[JOINT COMMITTEE PRINT]

REPORT TO THE HOUSE COMMITTEE ON WAYS AND MEANS ON PRESENT LAW AND SUGGESTIONS FOR REFORM SUBMITTED TO THE TAX REFORM WORKING GROUPS

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

May 6, 2013

U.S. Government Printing Office
Washington: 2013

JCS-3-13

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INTRODUCTION

On February 13, 2013, Ways and Means Committee Chairman Dave Camp and Ranking Member Sander Levin announced the formation of 11 Ways and Means Committee Tax Reform Working Groups.[1] The mission of each working group was to review current law in its designated area, research relevant issues, and compile related feedback from stakeholders, academics and think tanks, practitioners, the general public, and colleagues in the House of Representatives.

This document,[2] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides an overview of the Internal Revenue Code ("Code")[3] as in effect for 2013 and provides a more detailed description of the Code provisions relevant to the topic area of each working group. The document also summarizes the suggestions for reform and other commentary submitted by the public to the various working groups through http://waysandmeans.house.gov/taxreform/workinggroups.htm. In addition, at the request of Chairman Camp and Ranking Member Levin, the document briefly summarizes a selection of proposals to reform the Federal tax system that members of Congress, commissions, and others have presented to policy makers over the past several years.

Parts One and Two of this document provide a description of present law. Part Three summarizes selected tax reform proposals. Part Four summarizes the feedback received by the various working groups.

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[1] The Appendices provide the press releases of Ways and Means Chairman Dave Camp and Ranking Member Sander Levin which describe the missions of the working groups and the process by which the public can share information with the working groups.

[2] This document may be cited as follows: Joint Committee on Taxation, *Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups* (JCS-3-13), May 6, 2013.

[3] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended.

I. OVERVIEW OF PRESENT LAW FEDERAL TAX SYSTEM

A. Individual Income Tax

In general

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income.[4] Taxable income equals the taxpayer's total gross income less certain exclusions, exemptions, and deductions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may face additional liability if the alternative minimum tax applies. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

Adjusted gross income

Under the Internal Revenue Code of 1986 (the "Code"), gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[5] trusts or estates.[6] Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include trade or business expenses, capital losses, contributions to a qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), certain moving expenses, certain education-related expenses, and alimony payments.

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[4] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

[5] In general, partnerships and S corporations are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of such entities is passed through and taxed to the owners at the individual level. A business entity organized as a limited liability company ("LLC") under applicable State law generally is treated as a partnership for Federal income tax purposes.

[6] In general, estates and most trusts pay tax on income at the entity level, unless the income is distributed or required to be distributed under governing law or under the terms of the governing instrument. Such entities determine their tax liability using a special tax rate schedule and are subject to the alternative minimum tax. Certain trusts, however, do not pay Federal income tax at the trust level. For example, certain trusts that distribute all income currently to beneficiaries are treated as pass-through or conduit entities (similar to a partnership). Other trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

Taxable income

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2013, the amount deductible for each personal exemption is $3,900. This amount is indexed annually for inflation. Additionally, the personal exemption phase-out ("PEP") reduces a taxpayer's personal exemptions by two percent for each $2,500 ($1,250 for married filing separately), or fraction thereof, by which the taxpayer's AGI exceeds $250,000 (single), $275,000 (head-of-household), $300,000 (married filing jointly) and $150,000 (married filing separately).[7] These threshold amounts are indexed for inflation.

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2013, the amount of the standard deduction is $6,100 for single individuals and married individuals filing separate returns, $8,950 for heads of households, and $12,200 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[8] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income**,** sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). Additionally, the total amount of itemized deductions allowed is reduced by $0.03 for each dollar of AGI in excess of $250,000 (single), $275,000 (head-of-household), $300,000 (married filing jointly) and $150,000 (married filing separately).[9] These threshold amounts are indexed for inflation.

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[7] A taxpayer thus has all personal exemptions completely phased out at incomes of $372, 501 (single), $397,501 (head-of-household), $422,501 (married filing jointly) and $211,251 (married filing separately).

[8] For 2013, the additional amount is $1,200 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,500. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2013) of $2,400 or $3,000, as applicable.

[9] This rule is sometimes referred to as the "Pease limitation." A taxpayer may not lose more than 80 percent of his or her deductions as a result of this provision.

Table 1.–2013 Standard Deduction and Personal Exemption Values

Standard Deduction	
Married Filing Jointly	$12,200
Head of Household	$8,950
Single and Married Filing Separately	$6,100
Personal Exemptions	$3,900

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains; those rates apply for both the regular tax and the alternative minimum tax.

Regular tax liability

To determine regular tax liability, a 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. For 2013, the regular individual income tax rate schedules are as follows:

Table 2.–Federal Individual Income Tax Rates for 2013

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $87,850
Over $183,250 but not over $398,350	$44,603.25 plus 33% of the excess over $183,250
Over $398,350 but not over $400,000	$115,586.25 plus 35% of the excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000
Heads of Households	
Not over $12,750	10% of the taxable income
Over $12,750 but not over $48,600	$1,275 plus 15% of the excess over $12,750
Over $48,600 but not over $125,450	$6,652.50 plus 25% of the excess over $48,600
Over $125,450 but not over $203,150	$25,865 plus 28% of the excess over $125,450
Over $203,150 but not over $398,350	$47,621 plus 33% of the excess over $203,150
Over $398,350 but not over $425,000	$112,037 plus 35% of the excess over $398,350
Over $425,000	$121,364.50 plus 39.6% of the excess over $425,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,850	10% of the taxable income
Over $17,850 but not over $72,500	$1,785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50 plus 25% of the excess over $72,500
Over $146,400 but not over $223,050	$28,457.50 plus 28% of the excess over $146,400

Over $223,050 but not over $398,350	$49,919.50 plus 33% of the excess over $223,050
Over $398,350 but not over $450,000	$107,768.50 plus 35% of the excess over $398,350
Over $450,000	$125,846 plus 39.6% of the excess over $450,000
Married Individuals Filing Separate Returns	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $73,200	$4,991.25 plus 25% of the excess over $36,250
Over $73,200 but not over $111,525	$14,228.75 plus 28% of the excess over $73,200
Over $111,525 but not over $199,175	$24,959.75 plus 33% of the excess over $111,525
Over $199,175 but not over $225,000	$53,884.25 plus 35% of the excess over $199,175
Over $225,000	$62,923 plus 39.6% of the excess over $225,000

An individual's marginal tax rate may be reduced by the allowance of a deduction equal to a percentage of income from certain domestic manufacturing activities.[10]

Alternative minimum tax liability

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For 2013, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $179,500 ($89,750 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The breakpoint between the 26-percent and 28-percent bracket is indexed for inflation. 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 taxpayer's taxable income increased by the taxpayer's tax preferences 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.

The exemption amounts for 2013 are: (1) $80,800 in the case of married individuals filing a joint return and surviving spouses; (2) $51,900 in the case of other unmarried individuals; (3) $40,400 in the case of married individuals filing separate returns; and

[10] This deduction is described in more detail below in the summary of the tax rules applicable to corporations.

(4) $23,100 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $153,900 in the case of married individuals filing a joint return and surviving spouses, (2) $115,400 in the case of other unmarried individuals, and (3) $76,950 in the case of married individuals filing separate returns or an estate or a trust. These amounts are indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI.

Special capital gains and dividends rates

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A maximum rate applies to capital gains and dividends. For 2013, the maximum statutory rate of tax on the adjusted net capital gain of an individual is 20 percent (exclusive of the additional 3.8 percent tax on net investment income) on any amount of gain that otherwise would be taxed at a 39.6 rate. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise taxed at rates greater than 15-percent but less than 39.6 percent is taxed at a 15 percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Dividends are generally taxed at the same rate as capital gains.

Credits against tax

An individual may reduce his or her tax liability by any available tax credits. In some instances, a permissible credit is "refundable", *i.e.*, it may result in a refund in excess of any credits for withheld taxes or estimated tax payments available to the individual. Two major credits are the child tax credit and the earned income credit.

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000.[11] The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income 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. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit[12] (the additional child tax credit) equal to 15 percent of earned income in excess of $3,000.[13]

A refundable earned income tax credit ("EITC") is available to low-income workers who satisfy certain requirements. The amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has one, two, more than two, or no qualifying children. In 2013, the maximum EITC is $6,044 for taxpayers with more than two qualifying children, $5,372 for taxpayers with two qualifying children, $3,250 for taxpayers with one qualifying child, and $487 for taxpayers with no qualifying children. The credit amount begins to phaseout at an income level of $17,530 ($7,970 for taxpayers with no qualifying children). The phaseout percentages are 15.98 for taxpayers with one qualifying child, 17.68 for two or more qualifying children, and 7.65 for no qualifying children.

Tax credits are also allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain education expenditures, certain child care expenditures, and for certain elderly or disabled individuals. Credits allowed against the regular tax are allowed against the alternative minimum tax.

Tax on net investment income

For taxable years beginning after December 31, 2012, 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 or the excess of modified adjusted gross income over the threshold amount.[14] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.[15]

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[11] A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

[12] The refundable credit may not exceed the maximum credit per child of $1,000.

[13] Families with three or more children may determine the additional child tax credit using an alternative formula, if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit.

[14] The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Code (relating to income taxes).

[15] These amounts are not indexed for inflation.

Net investment income is the excess of (1) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (b) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities, over (2) deductions properly allocable to such gross income or net gain.

For purposes of this tax, modified adjusted gross income is AGI increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.[16]

[16] The tax does not apply to a nonresident alien or to a trust in which all the unexpired interests are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

B. Corporate Income Tax

Taxable income

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.[17]

The taxable income of a corporation generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year may be carried back two years and carried forward 20 years. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

The Code also specifies certain expenditures that may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[18] certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, as well as fines, penalties, bribes, kickbacks and illegal payments.

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[17] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

Under subchapter S of the Code, a qualified small business corporation may elect not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders.

[18] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

Tax liability

A corporation's regular income tax liability generally is determined by applying the following tax rate schedule to its taxable income.

Table 3.–Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0-$50,000	15 percent of taxable income
$50,001-$75,000	25 percent of taxable income
$75,001-$10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

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

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years and carried forward five years.

Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the Code.[19]

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include credits for biofuels and renewable power, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the research credit, the low-income housing credit

[19] With a nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate of 0.91 * 35, or 31.85 percent. A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

(applicable to investment in certain low-income housing projects), the empowerment zone employment credit (applicable to wages paid to certain residents of, or employees in, empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals). Unused credits generally may be carried back one year and carried forward twenty years.

A foreign tax credit is available, subject to limitations, for certain foreign income taxes paid or accrued. Foreign income taxes limited in a tax year may be carried back one year or forward ten years.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Minimum tax

A corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[20] Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences 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. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceed its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

[20] The exemption amount is phased out for corporations with income above certain threshold, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits.[21] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[22] Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at a rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder level tax in addition to the corporate level tax on accumulated earnings or undistributed personal holding company income.

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[21] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

[22] This double taxation is mitigated by a reduced tax rate generally applicable to dividend income of individuals.

C. Estate, Gift and Generation-Skipping Transfer Taxes

The United States generally imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $14,000 (for 2013) or less per donor and per donee generally are not subject to tax.

An estate tax also is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.[23] The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

The gift and estate taxes are unified such that a single graduated rate schedule and effective exemption amount apply to an individual's cumulative taxable gifts and bequests. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 40 percent on cumulative taxable transfers over $1,000,000. A unified credit of $2,045,800 (for 2013) is available with respect to taxable transfers by gift or at death. This credit effectively exempts a total of $5.25 million[24] (for 2013) in cumulative taxable transfers from the gift tax or the estate tax. The unified credit thus generally also has the effect of rendering the marginal rates below 40 percent inapplicable. Unused exemption as of the death of a spouse generally is available for use by the surviving spouse; this feature of the law sometimes is referred to as exemption portability.

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate or gift tax that is normally imposed on such transfers. This tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than

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[23] In addition to interests in property owned by the decedent at the time of death, the Federal estate tax also is imposed on (1) life insurance that was either payable to the decedent's estate or in which the decedent had an incident of ownership at death, (2) property over which the decedent had a general power of appointment at death, (3) annuities purchased by the decedent or his employer that were payable to the decedent before death, (4) property held by the decedents as joint tenants, (5) property transferred by the decedent before death in which the decedent retained a life estate or over which the decedent had the power to designate who will possess or enjoy the property, (6) property revocably transferred by the decedent before death, and (7) certain transfers taking effect at the death of the decedent.

[24] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, establishes an exemption amount of $5 million for 2010 and 2011 and indexes this amount for inflation for years after 2011. The American Taxpayer Relief Act of 2012 makes permanent the exemption provisions of the 2010 Act.

one generation below that of the transferor. For 2013, the generation-skipping transfer tax is imposed at a flat rate of 40 percent on generation-skipping transfers in excess of $5.25 million.

D. Social Insurance Taxes

In general

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. The Federal Insurance Contributions Act ("FICA") imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($113,700 in 2013); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages.[25] In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer.

As a parallel to FICA taxes, the Self-Employment Contributions Act ("SECA") imposes taxes on the net income from self-employment of self-employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies.[26]

In addition to FICA taxes, employers are subject to a Federal unemployment insurance payroll tax equal to 6 percent of the total wages of each employee (up to $7,000) on covered employment. Employers are eligible for a Federal credit equal to 5.4 percent for State unemployment taxes, yielding a 0.6 percent effective tax rate. Federal unemployment insurance payroll taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

Additional hospital insurance tax on certain high-income individuals

For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a specific threshold amount.[27] However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return,

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[25] Since 1994, the HI payroll tax has not been subject to a wage cap.

[26] For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

[27] Sec. 3101(b), as amended by the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148.

$125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarried individual, head of household or surviving spouse).[28]

The same additional HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold amount.[29]

[28] These threshold amounts are not indexed for inflation.

[29] Sec. 1402(b).

E. Major Excise Taxes

The Federal tax system imposes excise taxes on selected goods and services. Generally, excise taxes are taxes imposed on a per unit or ad valorem (*i.e.*, percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous products (*e.g.*, the tax on ozone depleting chemicals, and a tax on crude oil and certain petroleum products to fund the Oil Spill Liability Trust Fund), coal, certain telephone communications (*e.g.* local service), certain wagers, certain medical devices, indoor tanning services, and vehicles lacking in fuel efficiency.[30] Additionally, an annual fee is imposed on certain manufacturers and importers of branded prescription drugs pursuant to specified government programs. The largest excise taxes in terms of revenue (for fiscal year 2010) are those for gasoline motor fuel ($25.1 billion), domestic cigarettes ($14.9 billion), diesel motor fuel ($8.6 billion), and domestic air tickets ($7.6 billion).[31]

Revenues from certain Federal excise taxes are dedicated to trust funds (*e.g.*, the Highway Trust Fund) for designated expenditure programs, and revenues from other excise taxes (*e.g.*, alcoholic beverages) go to the General Fund for general purpose expenditures.

Table 4.–2013 Federal Excise Tax Rates for Selected Taxed Products or Services

Gasoline Motor Fuel	18.3 cents per gallon
Diesel Motor Fuel	24.3 cents per gallon
Domestic Cigarettes	$50.33 per thousand small cigarettes; $105.69 per thousand large cigarettes.
Domestic Air Tickets	7.5 percent of fare, plus $3.90 (2013) per domestic flight segment generally.

[30] See Joint Committee on Taxation, *Present Law and Background Information on Federal Excise Taxes* (JCX-1-11), January 2011, for a description the various Federal excise taxes.

[31] Internal Revenue Service, *Statistics of Income Bulletin*, Historical Table 20, "Federal Excise Taxes Reported to or Collected By the Internal Revenue Service, Alcohol and Tobacco Tax and Trade Bureau, and Customs Service, By Type of Excise Tax, Fiscal Years 1999-2010," http://www.irs.gov/pub/irs-soi/histab20.xls (2011).

II. DETAILS OF PRESENT LAW BY WORKING GROUP TOPIC AREA

A. Present Law: Charitable/Exempt Organizations

1. Tax-exempt status

Overview of the Tax-Exempt Sector

Since the inception of the Federal income tax, the Congress has exempted certain types of entities from income taxation. Many exempt entities, such as charitable organizations, are familiar. Yet charitable organizations are but one type of exempt entity. The benefit of tax exemption is extended to groups as diverse as social welfare organizations, title holding companies, fraternal organizations, small insurance companies, credit unions, cooperative organizations, political organizations, and cemetery companies.

There are now 29 different types of organizations listed in the main exemption section of the Code (section 501(c)), and numerous other exemptions provided elsewhere. As of February 11, 2013, there were more than 1.43 million tax-exempt section 501(c) organizations listed in the IRS Business Master File, of which more than 1.06 million were charitable organizations described in section 501(c)(3) of the Code.[32]

The following table lists types of section 501(c) organizations by subsection of the Code and summarizes selected operational rules.

[32] This figure excludes roughly half of an estimated 300,000 religious congregations, which are not required to apply for recognition of exempt status or file annual information returns with the IRS.

TABLE 5.−TYPES AND TAX TREATMENT OF SECTION 501(C) ORGANIZATIONS

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(1)	Corporations organized under Act of Congress	1934	U.S. instrumentality	No	Generally No	Only if exclusively for public purposes	No	No	447
501(c)(2)	Title holding corporations	1916	Holding title to property for another exempt organization	Yes	Generally No	No	No	Optional	4,496
501(c)(3)	Charitable organizations	1894	Religious, charitable, scientific, educational, etc.	Yes	Generally No (but private foundations are subject to tax on net investment income)	Yes	Yes	Yes (except for certain organizations including churches and small organizations)	1,063,484
501(c)(4)	Social welfare organizations	1913	Promoting the common good and general welfare of people of a community	Yes	Generally No	No	Yes	Optional	85,502

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(5)	Labor, agricultural, and horticultural organizations	1909	Betterment of the conditions of those engaged in labor, education, or horticulture	Yes	Generally No	No	Yes	Optional	46,732
501(c)(6)	Business leagues, chambers of commerce, trade associations, etc.	1913	Improvement of conditions in one or more lines of business	Yes	Generally No	No	Yes	Optional	63,494
501(c)(7)	Social clubs	1916	Social or recreational	Yes	Yes	No	Yes	Optional	46,868
501(c)(8)	Fraternal beneficiary societies	1894	Fraternal activities and payment of life, sick, accident, or other benefits to members	Yes	Generally No	Only if used for charitable purposes	No	Optional	49,085

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(9)	Voluntary employees' beneficiary associations	1928	Provides for payment of life, sick, accident, or other benefits to members or dependents, etc.	Yes	Yes	No	Yes (except for payments of life, sick, accident or other benefits to members)	Yes	6,945
501(c)(10)	Domestic fraternal societies	1969	Fraternal activities	Yes	Generally No	Only if used for charitable purposes	No	Optional	15,476
501(c)(11)	Teachers' retirement fund associations	1928	Payment of retirement benefits to teachers	Yes	Generally No	No	Generally Yes	Optional	8
501(c)(12)	Benevolent life insurance associations, rural cooperatives, etc.	1916	Activities of a mutually beneficial nature	Yes	Generally No	No	No	Optional	5,178

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(13)	Cemetery companies	1913	Operation of cemetery company or burial and cremation	Yes	Generally No	Only under certain circumstances (but not for estate and gift tax purposes)	Yes	Optional	8,411
501(c)(14)	State credit unions and mutual reserve funds	1951	Operating credit union for mutual purposes	Yes	Generally No	No	No	Optional	2,350
501(c)(15)	Certain small insurance companies	1916	Providing insurance to members at cost	Yes	Generally No	No	No	Optional	785
501(c)(16)	Crop-financing corporations	1928	Financing of crops for section 521 farmers' cooperative marketing associations	Yes	Generally No	No	No	Optional	12

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(17)	Supplemental unemployment benefit trusts	1960	Payment of supplemental unemployment compensation benefits	Yes	Yes	No	No	Yes	121
501(c)(18)	Funded pension trusts	1969	Trust that forms part of a pension plan funded only by employee contributions	Yes	Generally No	No	No	Optional	2
501(c)(19)	Veterans' organizations	1972	Organization of veterans; provision of insurance and other benefits	Yes (but certain insurance premium income excluded from UBTI)	Generally No	Limited to certain organizations of war veterans for income and gift taxes and to organizations incorporated by Act of Congress for estate tax	Yes	Optional	31,600

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(20) (expired for taxable years beginning after June 30, 1992)	Qualified group legal services plans	1976	Provision of legal services benefits	Yes	Yes	No	No	Yes	n.a.
501(c)(21)	Black lung benefits trusts	1977	Provision of black lung benefits	Yes	Generally No	No	No	Optional	28
501(c)(22)	Multiemployer Plan trusts	1980	Payment of withdrawal liability and withdrawal-type payments to plans	Yes	Generally No	No	No	Optional	0

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(23)	Pre-1880 veterans' organizations	1982	Organization of veterans; provision of insurance and other benefits	Yes	Generally No	Limited to certain organizations of war veterans for income gift taxes and to organizations incorporated by Act of Congress for estate tax	No	Optional	3
501(c)(24)	Employee Trusts	1986	Used in efforts to recover from an employer that terminated its pension plan assets sufficient to provide certain plan benefits	Yes	Generally No	No	No	Optional	0
501(c)(25)	Multi parent title holding organizations	1986	Hold title to assets for multiple parent exempt organizations	Yes	Generally No	No	No	Optional	800

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File (last updated 2/11/13)
501(c)(26)	High-risk individuals health care coverage organizations	1996	Coverage of medical care to certain high-risk individuals	Yes	Generally No	No	Yes	Optional	11
501(c)(27)	State-sponsored workmens' compensation insurance organizations	1996	Established by a State to reimburse members for losses arising under the workmens' compensation acts	Yes	Generally No	No	No	Optional	9
501(c)(28)	The National Railroad Investment Trust	2001	Manage and invest certain assets of Railroad Retirement System	Yes	Generally No	No	No	Not determined	n.a.
501(c)(29)	Qualified nonprofit health insurance issuers	2010	Offer qualified health insurance in the individual and small group markets	Yes	Generally No	No	Yes	Yes	2

Common Tax Law Features of Exempt Organizations

In general

Despite varying standards regarding qualification for exempt status, different categories of exempt organizations share some common characteristics. For example, many types of exempt organizations are subject to a prohibition against "private inurement," and most exempt organizations are subject to the general rules regarding the taxation of unrelated business income. Contributions to a limited number of exempt organizations are deductible as charitable contributions, while contributions to others may be deductible as a business expense but not as a charitable contribution. Most exempt organizations also are subject to rules regarding lobbying and political campaign activities and are required to file annual information returns. These characteristics, each common to two or more categories of exempt organization, are discussed in the following subsections.

Private inurement prohibition

The doctrine of private inurement generally prohibits an exempt organization from using its assets for the benefit of a person or entity with a close relationship to the organization. The private inurement prohibition applies to the following categories of exempt organizations: charitable organizations (section 501(c)(3));[33] social welfare organizations (section 501(c)(4)); agricultural, horticultural, and labor organizations (section 501(c)(5));[34] business leagues, trade associations, and other organizations exempt from tax under section 501(c)(6); social clubs (section 501(c)(7)); voluntary employees' beneficiary associations (section 501(c)(9)); teachers' retirement fund associations (section 501(c)(11)); cemetery companies (section 501(c)(13)); veterans' organizations (section 501(c)(19)); high-risk individuals health care coverage organizations (501(c)(26)); qualified nonprofit health insurance issuers (sec. 501(c)(29)); shipowners' protection and indemnity associations (sec. 526); and homeowners associations (sec. 528).

Section 501(c)(3) provides that an organization will qualify for charitable exempt status only if "no part of the net earnings [of the organization] inures to the benefit of any private shareholder or individual." Other sections of the Code describe the inurement prohibition using similar language. The regulations under section 501(a), which generally apply to organizations subject to the inurement proscription, define "private shareholder or individual" as "persons having a personal and private interest in the activities of the organization."[35] Inurement thus

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[33] Certain organizations are treated as charitable organizations described within section 501(c)(3) but are described elsewhere within section 501, namely cooperative hospital service organizations (sec. 501(e)), cooperative service organizations of operating educational organizations (sec. 501(f)), child care organizations (sec. 501(k)), and charitable risk pools (sec. 501(n)). Such organizations are subject to the private inurement prohibition.

[34] Although section 501(c)(5) of the Code does not state that section 501(c)(5) organizations are subject to the inurement prohibition, the Treasury regulations extend the prohibition to such organizations. Treas. Reg. sec. 1.501(c)(5)-1(a)(1).

[35] Treas. Reg. sec. 1.501(a)-1(c).

applies to transactions between applicable exempt organizations and persons sometimes deemed "insiders" of the organization, such as directors, officers, and key employees. The issue of private inurement often arises where an organization pays unreasonable compensation (*i.e.*, more than the value of the services) to such an insider. However, the inurement prohibition is designed to reach any transaction through which an insider is unduly benefited by an organization, either directly or indirectly.

There is no "de minimis" exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status. Until 1996, there was no sanction short of revocation of exempt status in the event of an inurement transaction. In 1996, however, Congress imposed excise taxes, frequently referred to as "intermediate sanctions," on "excess benefit transactions" between certain exempt organizations and "disqualified persons."[36] The intermediate sanctions rules, which apply only to transactions involving organizations exempt under sections 501(c)(3) and 501(c)(4), impose excise taxes on a disqualified person who receives an excess benefit and, under certain circumstances, on organization managers who approved the transaction. No such sanctions are presently imposed against the organization itself.

Unrelated business income tax

In general

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (*e.g.*, program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.[37]

The unrelated business income tax was introduced in 1950 to address the problem of unfair competition between for profit companies and nonprofit organizations conducting an unrelated for profit activity. The unrelated business income tax 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.[38] Most exempt

[36] Disqualified persons essentially are insiders of the organization, including those in a position to exercise substantial influence over the organization, as defined in section 4958.

[37] This is the case for social clubs (sec. 501(c)(7)), voluntary employees' beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in section 501(c)(17) and 501(c)(20). Sec. 512(a)(3). The investment income of certain non-501(c) and non-401(a) organizations not subject to the general unrelated business income tax rules also is subject to taxation. See, *e.g.*, sec. 527 (political organizations).

[38] Secs. 511-514.

organizations are subject to the tax.[39] An organization that is subject to the unrelated business income tax 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 it is not a primary purpose of the organization. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status.[40] By contrast, a charitable organization may not operate an unrelated trade or business as a substantial part of its activities.[41]

Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Treatment of income from controlled entities

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary, and generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. Interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

Under a special, temporary rule for payments made pursuant to binding written contracts in effect on August 17, 2006, the income inclusion rule of section 512(b)(13) applies only to the extent the payment received or accrued by the controlling exempt organization exceeds the

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[39] Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

[40] Because the exempt purposes of organizations differ, there may be differences in application of the unrelated business income tax rules, in particular, the determination of whether an activity is substantially related to an organization's exempt purposes.

[41] Treas. Reg. sec. 1.501(c)(3)-1(e).

amount that would have been paid in an arm's-length transaction. The special rule does not apply to payments received or accrued after December 31, 2013.[42]

Contributions

As discussed in greater detail below, another feature of a minority of tax-exempt organizations is that contributions to such organizations may be deductible by the donor as charitable contributions for income, estate, and gift tax purposes. Contributions to charitable organizations, for example, generally are deductible for income, estate, and gift tax purposes, although the amount of deduction may be affected by such factors as the recipient organization's classification as a public charity or private foundation (discussed below) and the type of property contributed. Other types of organizations that are eligible recipients of charitable contributions include: certain Federal, State, and local government entities, if the contribution is exclusively for public purposes; certain fraternal beneficiary societies, if the contributions are used for charitable purposes; cemetery companies, if the contributions are used for certain purposes; and certain organizations of war veterans.[43]

Contributions to other types of exempt organizations generally are not deductible as charitable contributions. Under certain circumstances, however, contributions to a membership organization, such as a social welfare organization or trade association, may be deductible as a business expense under section 162.

Lobbying and political campaign activities

Tax-exempt organizations are also subject to rules regarding the permissible level of lobbying and political campaign activities. In general, the lobbying and political activity rules applicable to charitable organizations are more limiting than the rules applicable to other types of exempt organizations.

Charitable organizations may engage in only a limited amount of lobbying.[44] Other types of exempt organizations, however, generally are not limited in their lobbying activities, so long as the lobbying is related to exempt purposes.

Charitable organizations are subject to an absolute prohibition on political campaign activity, which is defined as "participat[ing] in, or interven[ing] in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any

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[42] Sec. 512(b)(13)(E).

[43] Sec. 170(c). Certain contributions to cemetery companies are deductible for income tax purposes, but not for estate or gift tax purposes. Otherwise, the categories of eligible recipients of deductible charitable contributions are largely coextensive for income, estate, and gift tax purposes. See secs. 170(c), 2055(a), and 2522(a).

[44] Lobbying activities of charitable private foundations constitute prohibited "taxable expenditures." See Part II.D.

candidate for public office."[45] Other exempt organizations, including section 501(c)(4) social welfare organizations, generally may engage in political campaign activities so long as such activity is not a primary activity of the organization. Certain expenditures for political activities may, however, cause an organization to be subject to tax on such expenditures.[46]

Information returns

Exempt organizations are required to file an annual information return, Form 990 (Return of Organization Exempt From Income Tax), stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.[47] Exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain State institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.[48]

An organization that is required to file an information return, but that has gross receipts of less than $200,000 during its taxable year, and total assets of less than $500,000 at the end of its taxable year, may file Form 990-EZ. If an organization normally has gross receipts of $50,000 or less, it must file Form 990-N ("e-postcard"), if it chooses not to file Form 990 or Form 990-EZ. Private foundations are required to file Form 990-PF rather than Form 990.

Section 501(c)(3) Organizations

In general

The charitable sector[49] (*i.e.*, organizations described in section 501(c)(3)) is a significant part of the national economy. In general, the requirements for exempt status of an organization under section 501(c)(3) of the Code are that (1) the organization must be organized and operated exclusively for certain purposes; (2) there must not be private inurement to organization insiders; (3) there must be no more than an incidental private benefit to private persons who are not organization insiders; (4) no substantial part of the organization's activities may be lobbying; and (5) the organization may not participate or intervene in political campaign activities. Permitted

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[45] Sec. 501(c)(3).

[46] Sec. 527(f).

[47] Sec. 6033(a). An organization that has not received a determination of its tax-exempt status, but that claims tax-exempt status under section 501(a), is subject to the same annual reporting requirements and exceptions as organizations that have received a tax-exemption determination.

[48] Sec. 6033(a)(2)(A); Treas. Reg. secs. 1.6033-2(a)(2)(i) and (g)(1).

[49] The word "charitable" generally is used in this pamphlet to include any of the purposes described in section 501(c)(3), *e.g.*, religious, educational, scientific, and other.

purposes are religious, charitable, scientific, testing for public safety, literary, educational, the fostering of national or international amateur sports competition, or the prevention of cruelty to children or animals. Failure to satisfy any of these requirements should result in an organization not qualifying for exempt status under section 501(c)(3), or should result in a loss of such status once a violation is detected by the IRS.

Threshold requirements for exempt status

Organizational and operational tests

Most of the Federal law of charitable organizations is designed around ensuring that each of the above requirements is satisfied by an organization initially and on an ongoing basis. By statute, an organization qualifies as charitable only if it is organized and operated exclusively for exempt purposes. The regulations require in addition that an organization serve a public rather than a private interest.[50]

Satisfaction of the organizational test may be achieved by adopting certain formal requirements in the founding documents of the organization. For example, an organization must limit its purposes to one or more exempt purposes and must not be permitted to engage in activities that do not further exempt purposes (except to an insubstantial extent). Thus, a charitable organization may not have something noncharitable as its purpose.[51] In addition, the organizational documents generally must prohibit violation of the lobbying and legislative prohibitions, and must provide that the organization's assets are dedicated to an exempt purpose in perpetuity.[52] An organization's assets are considered dedicated to an exempt purpose if, for example, upon dissolution, such assets are distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose.[53] An organization fails the organizational test if its articles of organization empower it to engage in activities that characterize it as an "action" organization, *e.g.*, if its primary purpose may be accomplished only by legislation and it advocates for such aim.

The operational test generally requires that an organization operate consistent with the requirements of the Code, *i.e.*, the private inurement, lobbying, and political activities rules must be adhered to in the organization's operations.[54] Violation of such requirements means an organization fails the operational test, is therefore not operated exclusively for charitable purposes, and should lose tax-exempt status.

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[50] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii) and (iii).

[51] This is so even if the organization's operations are consistent with charitable purposes. Treas. Reg. sec. 1.501(c)(3)-1(b)(1)(iv).

[52] See Treas. Reg. sec. 1.501(c)(3)-1(b)(3) and (4).

[53] Treas. Reg. sec. 1.501-1(b)(4).

[54] See Treas. Reg. sec. 1.501(c)(3)-1(c).

The operational test enforces and explicates the Code requirement that an organization be operated exclusively for exempt purposes. Under Treasury regulations, an organization is regarded as operating exclusively for exempt purposes "only if it engages *primarily* in activities which accomplish" exempt purposes.[55] "An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[56] Thus, under the regulations, "exclusively" is not given its common sense meaning of "solely" but rather is construed as "primarily," with the result that an organization may to a certain extent be operated for nonexempt purposes.[57] In other words, the law expressly permits a charitable organization to conduct activities that do not accomplish exempt purposes, so long as such activities are not substantial. In addition, as held by the Supreme Court, "the presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes."[58] Applying this test, the Court held that an organization with an "important" nonexempt purpose was subject to tax. Thus, under the regulation, insubstantial nonexempt activities are consistent with exempt status, and, under the Court's holding, nonsubstantial nonexempt purposes are consistent with exempt status.

Prohibitions against private inurement and private benefit

Section 501(c)(3) organizations are subject to the prohibition against private inurement, discussed above, which generally prohibits an organization from using its assets for the benefit of a person or entity with a close relationship to the organization. In addition, section 501(c)(3) organizations (but not other tax-exempt organizations) are subject to a prohibition against private benefit. Unlike the absolute prohibition against private inurement, *de minimis* private benefit is permitted.

Political and lobbying activities of charitable organizations

Charitable organizations are prohibited from engaging in political campaign activity and face limits on the amount of permissible lobbying activity.

Lobbying activities.−As noted, under present law, an organization does not qualify for tax-exempt status as a charitable organization unless "no substantial part" of its activities constitutes "carrying on propaganda, or otherwise attempting, to influence legislation" (commonly referred to as "lobbying").[59] Public charities may engage in limited lobbying activities, provided that such activities are not substantial, without losing their tax-exempt status

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[55] Treas. Reg. sec. 1.501(c)(3)-1(c)(1) (emphasis added).

[56] Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

[57] As a practical matter, if "exclusively" were construed by regulations in its ordinary sense, an organization would not be permitted to engage in unrelated business income tax activities, rendering the unrelated business income tax rules moot.

[58] *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945).

[59] Sec. 501(c)(3).

and generally without being subject to tax. In contrast, private foundations are subject to a restriction that lobbying activities, even if insubstantial, may result in the foundation being subject to penalty excise taxes.[60]

For purposes of determining whether lobbying activities are a substantial part of a public charity's overall functions, a public charity may choose between two standards, the "substantial part" test or the "expenditure" test.[61] The substantial part test derives from the statutory language quoted above and uses a facts and circumstances approach to measure the permissible level of lobbying activities. The expenditure test sets specific dollar limits, calculated as a percentage of a charity's total exempt purpose expenditures, on the amount a charity may spend to influence legislation.[62]

Political campaign activities.−As noted, under present law, charitable organizations may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[63] The prohibition on such political campaign activity is absolute and, in general, includes activities such as making contributions to a candidate's political campaign, endorsements of a candidate, lending employees to work in a political campaign, or providing facilities for use by a candidate. Many other activities may constitute political campaign activity, depending on the facts and circumstances. The sanction for a violation of the prohibition is loss of the organization's tax-exempt status.

For organizations that engage in prohibited political campaign activity, the Code provides three penalties that may be applied either as alternatives to revocation of tax exemption or in addition to loss of tax-exempt status: an excise tax on political expenditures,[64] termination assessment of all taxes due,[65] and an injunction against further political expenditures.[66]

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[60] Sec. 4945(d)(1).

[61] Secs. 501(c)(3), 501(h), and 4911. Churches and certain church-related entities may not choose the expenditure test. Sec. 501(h)(5).

[62] Secs. 501(h) and 4911.

[63] Sec. 501(c)(3).

[64] Sec. 4955.

[65] Sec. 6852(a)(1).

[66] Sec. 7409.

Public charity versus private foundation

In general

If an organization satisfies each of the requirements for charitable status, there is a further question of what type of charitable organization it is. A section 501(c)(3) organization is either a public charity or a private foundation. Certain organizations also may qualify as public charities as a matter of law (*e.g.*, churches, hospitals). The classification matters because private foundations generally are subject to more restrictions on their activities than are public charities, are subject to tax on their net investment income, and contributions to private foundations generally do not receive as favorable treatment as do contributions to public charities for purposes of the charitable contribution deduction.

Qualifying as a public charity

An organization may qualify as a public charity in several ways.[67] For example:

- It may be a specified type of organization, such as a church, educational institution, hospital and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit.[68]
- It may qualify as a publicly supported public charity if at least one-third of its total support is from governmental units or the general public,[69] or, failing this mechanical test, if it passes a "facts and circumstances" test.[70] In general, this includes publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or to the general public, and organizations such as the American Red Cross.[71]
- It may qualify as a publicly supported public charity based on support received through the operation of trades or businesses that are related to such organizations' exempt purposes, *i.e.*, if it normally receives 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

[67] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[68] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[69] Treas. Reg. sec. 1.170A-9(e)(2).

[70] Treas. Reg. sec. 1.170A-9(e)(3).

[71] Treas. Reg. sec. 1.170A-9(e)(1)(ii).

furnishing of facilities in connection with activities that are related to the organization's exempt purposes.[72]

- It may qualify as a "supporting organization" by providing support to another section 501(c)(3) entity that is not a private foundation.[73]
- It may qualify by being organized and operated exclusively for testing for public safety.[74]

An organization that does not fit within any of the above categories is a private foundation. In general, private foundations are funded from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

Private foundation operational rules and excise taxes

Unlike public charities, private foundations are subject to tax on their net investment income at a rate of 2 percent (1 percent in some cases).[75] Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are required to make a minimum amount of charitable distributions each year,[76] are limited in the extent to which they may control a business,[77] may not make speculative investments,[78] and may not make certain expenditures (including expenditures for noncharitable purposes, lobbying, political activities, grants to individuals without prior IRS approval, grants to organizations other than public charities and certain foundations unless special procedures are followed).[79] Violations result in excise taxes on the foundation and, in the case of speculative investments and taxable expenditures, on the management of the foundation.

Other Types of Tax-Exempt Organizations

As is discussed above, the benefit of tax exemption is extended to groups as diverse as social welfare organizations, title holding companies, fraternal organizations, small insurance

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[72] 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).

[73] Sec. 509(a)(3).

[74] Sec. 509(a)(4).

[75] Sec. 4940.

[76] Sec. 4942.

[77] Sec. 4943.

[78] Sec. 4944.

[79] Sec. 4945.

companies, credit unions, cooperative organizations, political organizations, and cemetery companies. This subsection provides additional information regarding some of the more common types of organizations, including: social welfare organizations (section 501(c)(4)); labor and horticultural organizations (section 501(c)(5)); business leagues and chambers of commerce (section 501(c)(6)); political organizations (section 527); governmental entities; and State credit unions (section 501(c)(14)).

Although these organizations share many of the common tax-law features of exempt organizations discussed above, each category has unique requirements.

Social welfare organizations

In general

Since 1913, there has been a tax exemption for civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.[80] An organization is operated exclusively for the promotion of social welfare if it is engaged primarily in promoting in some way the common good and general welfare of the people of a community.[81] For example:

- A nonprofit firefighters' association that provides firefighters with retirement benefits, which are funded by government sources and which are the exclusive retirement benefits provided to these firefighters, qualifies for exemption as a social welfare organization.[82]

- An organization that provides and maintains free off-street parking to anyone visiting a city's downtown business district qualifies for exemption as a social welfare organization.[83]

- A nonprofit organization formed to represent the public interest at legislative and administrative hearings on tax matters qualifies for exemption as a social welfare organization.[84]

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[80] Tariff Act of 1913, ch. 16, sec. 11(G)(a), 38 Stat. 172; sec. 501(c)(4). The private inurement prohibition was enacted in 1996. Exemption under section 501(c)(4) also includes exemption for certain local associations of employees meeting certain membership requirements. This exemption was introduced in 1924. Revenue Act of 1924, ch. 234, sec. 231(8), 43 Stat. 282.

[81] Treas. Reg. sec. 1.501(c)(4)-1(a)(2).

[82] Rev. Rul. 87-126, 1987-2 C.B. 150.

[83] Rev. Rul. 81-116, 1981-1 C.B. 333.

[84] Rev. Rul. 71-530, 1971-2 C.B. 237.

Lobbying and political activities

The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office; however, social welfare organizations are permitted to engage in political campaign activity so long as it is not the organization's primary activity. The lobbying activities of a social welfare organization generally are not limited. An organization is not operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations that are operated for profit.

Comparison with section 501(c)(3) organizations

The concept of "social welfare" for purposes of section 501(c)(4) overlaps considerably with the definition of "charitable" under section 501(c)(3). As a result, many organizations could qualify for exemption under either section.[85] However, an organization's choice between social welfare status and charitable status will result in different benefits and burdens. For example, a donor to a charitable organization may take a charitable deduction, whereas a donor to a social welfare organization may not take a charitable deduction. As a result, charitable organizations are generally viewed as having an advantage in attracting contributions.

On the other hand, social welfare organizations have greater operational flexibility than charitable organizations. For example, whereas social welfare organizations may engage in an unlimited amount of lobbying without jeopardizing their exempt status, charitable organizations may engage in only a limited amount of lobbying.[86] In addition, while social welfare organizations may engage in political campaign activity so long as it is not a primary activity of the organization, charitable organizations are prohibited from engaging in any political campaign activity.[87] Social welfare organizations need not, but may, seek formal IRS recognition of exempt status, whereas charitable organizations are required to file an application for recognition of exemption.[88]

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[85] The regulations under both sections recognize an overlap in exempt purposes. See Treas. Reg. sec. 1.501(c)(3)-1(d)(2) (definition of "charitable" for purposes of section 501(c)(3) includes the promotion of social welfare); Treas. Reg. sec. 1.501(c)(4) (providing that a social welfare organization will qualify for exemption as a charitable organization if it falls within the definition of "charitable" under section 501(c)(3) and meets certain other requirements).

[86] Compare sec. 501(c)(3) and Treas. Reg. sec. 1.501(c)(3)-1(c)(3) with sec. 501(c)(4).

[87] Compare sec. 501(c)(3) with sec. 501(c)(4) and Treas. Reg. sec. 1.501(c)(4)-1(a)(2)(ii).

[88] Sec. 508(a).

Labor, agricultural, or horticultural organizations

Since 1909, there has been a tax exemption for certain labor, agricultural,[89] or horticultural organizations,[90] no part of the net earnings of which inure to the benefit of any member. Such organizations must have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.[91] Labor unions are the typical example of a labor organization.

An organization generally is not exempt under this provision if its principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.[92] Contributions to labor, agricultural, and horticultural organizations are not deductible as charitable contributions. However, such payments may be deductible as business expenses if they are ordinary and necessary in the conduct of the taxpayer's trade or business.

Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues

Since 1913, there has been a tax exemption for business leagues and certain other organizations not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual.[93] A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.[94] Such an organization may not have as its primary activity performing "particular services" for members.[95] Many organizations known as "trade associations" may qualify for exempt status under this provision. For example, an organization that promotes the commercial fishing industry in a particular State by publishing information about advances in the industry and other information of common interest to fishermen in the State qualifies as a trade association under section 501(c)(6).[96]

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[89] In 1976, the term "agricultural" was defined as including "the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock." Sec. 501(g).

[90] 1909 Revenue Act, sec. 38, 36 Stat. 11; sec. 501(c)(5).

[91] Treas. Reg. sec. 1.501(c)(5)-1(a).

[92] Treas. Reg. sec. 1.501(c)(5)-1(b).

[93] Tariff Act of 1913, ch. 16, sec. 11(G)(a), 38 Stat. 172; sec. 501(c)(6).

[94] Treas. Reg. sec. 1.501(c)(6)-1.

[95] Treas. Reg. sec. 1.501(c)(6)-1.

[96] Rev. Rul. 75-287, 1975-2 C.B. 211.

Contributions to these types of organizations are not deductible as charitable contributions; however, they may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer's business.

Political organizations

Section 527 provides a limited exemption from Federal income tax of "political organizations." Political organizations are defined as a party, committee, association, fund, account, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for an "exempt function." An "exempt function" is defined, in turn, as influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed. A political organization will be subject to the highest rate of corporate income tax on its "political organization taxable income" defined as the organization's gross income other than "exempt function income,"[97] less the deductions directly connected with the production of such includible gross income.[98]

Governmental entities

Income of States, municipalities, other governments

In 1913, Congress specifically provided for exemption for entities that perform an essential governmental function.[99] The exemption applies to (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whether activities involve the exercise of an "essential governmental function" is generally decided on a case-by-case basis. Relevant factors include whether the activity is one traditionally considered "governmental," whether it involves the exercise of a governmental activity, and the extent of governmental financial interest in the activity. The income must be derived from a qualifying activity; it is not sufficient that the income be paid over to or benefit a qualifying activity. The second requirement, that the income "accrue to" a State or political

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[97] Exempt function income includes amounts received as (1) a contribution of money or other property; (2) membership dues; (3) proceeds from the conduct of bingo games as described in section 513(f)(2); and (4) proceeds from a political fund-raising or entertainment event or from the sale of political campaign materials other than amounts received in the ordinary course of a trade or business. Such amounts are required to be segregated in a separate account or accounts for the "exempt function" of the organization.

[98] Sec. 527(c)(1).

[99] Sec. 115. Separately, the constitutional doctrine of intergovernmental tax immunity generally provides that the Federal government will not tax the States.

subdivision, occurs when the State or subdivision has an unrestricted right to a proportionate share of the income.

Most such entities generally are not subject to taxation on unrelated business taxable income.[100] State colleges and universities, however, generally are subject to unrelated business income taxation.[101] Contributions to or for the use of State and local governments exclusively for public purposes generally are deductible for income, estate and gift tax purposes.[102]

United States instrumentalities

Since 1934, there has been exemption for corporations organized under an Act of Congress, if such corporations are instrumentalities of the United States.[103] U.S. instrumentalities include the Federal Deposit Insurance Corporation, the Reconstruction Finance Corporation, Federal Land Banks, Federal National Mortgage Association, Federal Reserve Banks, the Federal Savings and Loan Insurance Corporation, and the Pennsylvania Avenue Development Corporation. Federal credit unions organized and operated under the Federal Credit Union Act are instrumentalities of the United States.[104] U.S. instrumentalities are not subject to taxation on unrelated business taxable income.[105] Prior to 1934, exemption for many U.S. instrumentalities was provided in the act establishing the instrumentality. The general exemption provision was adopted "to bring the section into accord with the acts authorizing such exemptions and to avoid the necessity of referring to all such acts."[106]

Indian tribal governments

Since the Indian Tribal Government Tax Status Act of 1982, there has been an exemption for Indian tribal governments.[107] The exemption expressly provides that Indian tribal governments are treated as States for certain tax purposes. First, tribal governments may be recipients of deductible charitable contributions for income, estate, and gift tax purposes. Second, tribal governments are extended the treatment provided to States under the following excise taxes: tax on special fuels, manufacturers excise taxes, communications excise tax, and

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[100] Sec. 511(a)(2)(A).

[101] Sec. 511(a)(2)(B).

[102] Secs. 170(c)(1), 2055(a)(1), 2522(a)(1).

[103] Revenue Act of 1934, sec. 101(15), 48 Stat. 680; sec. 501(c)(1). See sec. 501(l) (listing certain exempt U.S. instrumentalities).

[104] See Rev. Rul. 89-94, 1989-2 C.B. 283. State credit unions are governed by other provisions.

[105] Sec. 511(a)(2)(A). Contributions to or for the use of a U.S. instrumentality generally are deductible for income, estate and gift tax purposes.

[106] H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934).

[107] Pub. L. No. 97-473 (1983); sec. 7871.

tax on use of certain highway vehicles. Special treatment relating to excise taxes is available to tribal governments only with regard to transactions involving the exercise of an essential governmental function[108] by the Indian tribal government. Third, taxes paid to Indian tribal governments are deductible for income tax purposes to the same extent as State taxes.[109] Fourth, Indian tribal governments may issue tax-exempt bonds and private activity bonds under certain conditions.

In addition, Indian tribal governments are treated as States for purposes of: (1) unrelated business income tax rules that apply to State colleges and universities, (2) treatment of amounts received under a disability and sickness fund maintained by a State, (3) the rules relating to tax-sheltered annuities, (4) original discount rules, (5) the tax on excess expenditures to influence legislation, and (6) private foundation rules.

State credit unions

Since 1951, there has been an exemption for credit unions without capital stock organized and operated for mutual purposes and without profit (not including Federal credit unions that are exempt as U.S. instrumentalities).[110] State law determines whether an organization formed under the laws of one of the States is a credit union for this purpose.[111] If an organization is not formed and does not operate under a State law governing credit unions, it generally is not a credit union.

2. Deduction for charitable contributions

Overview

In general

The Internal Revenue Code allows taxpayers to reduce their income, estate, and gift tax liabilities by taking deductions for contributions to certain organizations, including charities, Federal, State, local and Indian tribal governments, and certain other organizations. The rules describing these deductions are found in sections 170 (income tax charitable deduction), 2055 (estate tax charitable deduction), and 2522 (gift tax charitable deduction).

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable

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[108] See Secs. 4227, 4484, 6420(i)(4), 6421(j)(3), and 6427(p)(3), which refer to section 7871 for exemption provisions. Section 7871(e) limits the term essential governmental function to exclude any function that is not customarily performed by State and local governments with general taxing powers.

[109] Secs. 7871(a)(3) and 164(g)(2).

[110] Sec. 501(c)(14)(A). As discussed above, Federal credit unions generally are treated as United States instrumentalities, exempt from tax under section 501(c)(1).

[111] Rev. Rul. 69-282, 1969-1 C.B. 155 (holding that an organization formed under a State's general corporation law was not a credit union even though its charter required "mutuality of lender and borrower in the sense that any person borrowing from the organization must be a member").

contributions (*i.e.*, an organization or entity described in section 170(c), 2055(a), or 2522(a)). 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). Fourth, the transfer must be of money or property—contributions of services are not deductible.[112] Finally, the transfer must be substantiated and in the proper form. These requirements are discussed in greater detail below.

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

Effect of the deduction on taxable income

Because the charitable contribution deduction is an itemized deduction, its value in any tax year depends on the relative amount of the taxpayer's itemized deductions compared to his or her standard deduction, and the taxpayer's marginal tax rate.[113]

An individual computes his or her taxable income by reducing gross income by the sum of (i) the deductions allowable in computing adjusted gross income ("above-the-line deductions),[114] (ii) *either* the standard deduction *or* the sum of the itemized deductions, at the election of the taxpayer, and (iii) the deduction for personal exemptions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her income tax liability. A taxpayer may also reduce his or her income tax liability by certain tax credits. If a taxpayer takes the standard deduction rather than itemizing deductions in a tax year, then any charitable contributions the taxpayer makes in that year do not further reduce taxable income.

Overall limit on itemized deductions ("Pease limitation")

The total amount of most otherwise allowable itemized deductions (including the charitable deduction) is limited for certain upper-income taxpayers. 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 ("AGI") exceeds a threshold amount.

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[112] 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.

[113] The charitable deduction is also allowed for purposes of calculating alternative minimum taxable income.

[114] Above-the-line deductions include, among other things, trade or business expenses, losses from the sale or exchange of property, deductions attributable to rents and royalties, contributions to pensions and other retirement plans, certain moving expenses, and alimony payments.

For 2013, the threshold amounts are $250,000 for single taxpayers, $275,000 for heads of household, $300,000 for married couples filing jointly, and $150,000 for married taxpayers filing separately. These threshold amounts are indexed for inflation for years after 2013. The otherwise allowable itemized deductions may not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

Organizations Eligible to Receive Deductible Charitable Contributions

Section 170 permits donors to deduct contributions to the following kinds of organizations:

- Governmental entities. A State (including Indian tribal governments)[115] or United States possession (or political subdivision of either), or the United States or the District of Columbia, if the contribution is made exclusively for public purposes.
- Domestic charitable organizations. Specifically, a community chest, corporation, trust, fund, or foundation, organized or created in the United States or its possessions, or under the laws of the United States, any State, the District of Columbia or any possession of the United States, and organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.[116]
- Veterans organizations. A war veterans organization or its post, auxiliary, trust, or foundation organized in the United States or its possessions.
- Domestic fraternal societies. The society must operate under the lodge system, and the contribution must be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

[115] Indian tribal governments are treated as States for purposes of deductibility of contributions under section 170(c). See sec. 7871(a)(1)(A).

[116] The Code provides that for a charitable organization to be an eligible donee for income tax purposes, it must be created or organized in the United States (sec. 170(c)(2)), *i.e.*, it must be a domestic organization; the corresponding estate and gift tax provisions of the Code include no such explicit requirement (secs. 2055(a)(2) and 2522(a)(2)). However, section 508(d)(2)(B) provides that no income, estate or gift tax charitable deduction is allowed for a contribution to an organization that has not sought recognition from the IRS of its exempt status under section 501(c)(3).

- Cemetery companies.−A nonprofit cemetery company may receive a deductible contribution if the funds are irrevocably dedicated to the perpetual care of the cemetery as a whole and not a particular lot or mausoleum crypt.[117]

In general, no income tax deduction is available for gifts to individuals or to organizations that are not listed under section 170(c). Contributions to the following types of organizations, for example, typically are not deductible as charitable contributions: most social welfare organizations (described under section 501(c)(4));[118] labor organizations (described under section 501(c)(5)); business leagues and chambers of commerce (described under section 501(c)(6)); homeowners associations; and charities that are not in the proper organizational form or are organized in a foreign jurisdiction (as outlined below).

Other Requirements for Charitable Deduction

Donative intent

The term "contribution or gift" is generally interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. A payment or other transfer to a charity (regardless of whether it is called a "contribution") is not deductible if it is made in exchange or in return for an economic benefit.

To the extent a payment exceeds the fair market value of the benefit received from the charity, the excess portion may be deductible provided that the donor can demonstrate that he or she transferred the excess to charity with the intention of making a gift.[119]

Substantiation and other formal requirements

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.[120] 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.

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[117] Certain contributions to cemetery companies are deductible for income tax purposes, but not for estate or gift tax purposes. See secs. 170(c), 2055(a), and 2522(a).

[118] In a few limited situations, organizations described in section 501(c)(4) may be eligible donees described in section 170(c). This might include, for example, certain veterans organizations and certain volunteer fire companies.

[119] *United States v. American Bar Endowment*, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

[120] Sec. 170(f)(17).

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.[121]

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[122]

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.[123] 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.

Determining the Amount of the Income Tax Charitable Contribution Deduction

For Federal income tax purposes, the deductible portion of a charitable contribution generally is limited to a percentage of the taxpayer's income. In addition, in determining the deductible value of a charitable contribution for income tax purposes, the Code sometimes requires a reduction from the fair market value of appreciated property, resulting in a deductible amount (before considering percentage limits on deductibility) equal to the taxpayer's basis in the property or to some other amount that is less than the fair market value of the 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 AGI for a taxable year, disregarding any net operating loss carryback to the year under section 172.[124] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

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[121] 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).

[122] Sec. 6115.

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

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

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

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

Finally, more favorable percentage limits sometimes apply to contributions *to* the donee charity than to contributions that are *for the use of* the donee charity. Contributions of capital gain property *for the use of* public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base.[125] In contrast to property contributed directly *to* a charitable organization, property contributed *for the use of* an organization generally has been interpreted to mean property contributed *in trust for* the organization.[126] Charitable contributions of income interests (where deductible) also generally are treated as contributions *for the use of* the donee organization.

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[125] Under a special, temporary provision, certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

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

Table 6.–Charitable Contribution Percentage Limits For Individual Taxpayers[127]

	Ordinary Income Property and Cash	**Capital Gain Property *to* the Recipient**[128]	**Capital Gain Property *for the use of* the Recipient**
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30%[129]	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 year.[130] For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.[131]

Carryforwards of excess contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[132] In general, contributions carried over from a prior year

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

[128] 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.

[129] Under a special, temporary provision, 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.

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

[131] Sec. 170(b)(2)(C). Under a special, temporary provision, certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

[132] Sec. 170(d).

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 some other 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.[133] 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;[134] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;[135] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[136]

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.[137] Qualified appreciated stock is stock that is capital gain property and for which

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[133] 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).

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

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

[136] Sec. 170(e)(1)(B)(ii). 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.

[137] Sec. 170(e)(5).

(as of the date of the contribution) market quotations are readily available on an established securities market.[138]

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.

Enhanced deduction rules for certain contributions of inventory and other property

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

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.*, basis plus one-half of fair market value in excess of basis) or (2) two times basis.[139] To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.[140] Contributions to organizations that are not described in section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Under a temporary provision for contributions made before January 1, 2014, any taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.[141]

Selected statutory rules for specific types of property

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles,

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[138] Sec. 170(e)(5)(B).

[139] Sec. 170(e)(3).

[140] Sec. 170(e)(3)(A)(i)-(iii).

[141] Sec. 170(e)(3)(C).

intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report—and in many instances overstated—the value of the property for purposes of claiming a charitable deduction.

Vehicles.--Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and other intellectual property.--If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory)[142] to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.[143] In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).[144]

Clothing and household items.--Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization.

Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of

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[142] Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See sec. 1221(a)(3), 1231(b)(1)(C).

[143] Sec. 170(e)(1)(B)(iii).

[144] The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than $500 may be deducted if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.[145]

Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.[146]

Contributions of Partial Interests in Property

In general

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.[147] 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.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[148] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[149]

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[145] As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than $5,000.

[146] The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

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

[148] Sec. 170(a)(3).

[149] Treas. Reg. sec. 1.170A-5(a)(4). Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has "no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year." Treas. Reg. sec. 1.170A-5(a)(2).

A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[150] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[151] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[152]

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified conservation contributions

Exception from partial interest rule

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.[153] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

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[150] Sec. 170(f)(3)(B)(ii).

[151] Treas. Reg. sec. 1.170A-7(b)(1).

[152] Treas. Reg. sec. 1.170A-7(b)(1).

[153] Secs. 170(f)(3)(B)(iii) and 170(h).

Temporary provision allowing increased percentage limits and extended carryforwards

Under a temporary provision effective for contributions made in taxable years beginning before January 1, 2014,[154] preferential percentage limits and carryforward rules apply for qualified conservation contributions.

Fractional contributions of tangible personal property (including works of art)

As discussed above, an exception to the partial interest rule permits a charitable deduction for a contribution of an undivided portion of a donor's entire interest in property. Under this exception, a donor generally may take a deduction for a charitable contribution of a fractional interest in tangible personal property (such as a painting), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of undivided, fractional interests in the same property.[155] However, special valuation and deductibility rules apply to charitable contributions of fractional interests in tangible personal property, such as a contribution of a painting to a museum.

First, the value of a donor's charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) is determined under generally applicable rules (*e.g.*, based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee's exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of tangible personal property for income tax purposes, however, special rules apply. Specifically, the fair market value of the item is the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution.[156]

Second, the income tax charitable deduction and gift tax charitable deduction for a contribution of a partial interest in tangible personal property may be recaptured under certain circumstances, such as where the donor fails to contribute all of the donor's remaining interest in such property within a specified period of time, or where the donee charity fails to take substantial physical possession of the item or fails to use the item for an exempt use during such period of time, as required by the Code.[157] In any case in which there is a recapture of a

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[154] Sec. 170(b)(1)(E).

[155] See, *e.g.*, *Winokur v. Commissioner*, 90 T.C. 733 (1988).

[156] Sec. 170(o)(2).

[157] Sec. 170(o)(3). If, for example, an art museum described in section 501(c)(3) is the donee of a fractional interest in a painting and includes the painting in an art exhibit sponsored by the museum, such use generally satisfies the related-use requirement of the provision.

deduction, the provision also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

In addition, an income or gift tax charitable deduction generally is not allowed for a contribution of a fractional interest in an item of tangible personal property unless immediately before such contribution all interests in the item are owned (1) by the donor or (2) by the donor and the donee organization.[158]

Overview of The Estate and Gift Tax Charitable Deductions

A charitable deduction also is available for Federal estate and gift tax purposes.[159] In determining the value of a decedent's taxable estate for Federal estate tax purposes, the value of bequests or other transfers to certain qualified public or charitable organizations is subtracted from the value of the decedent's gross estate.[160] Similarly, in computing a taxpayer's taxable gifts for a year for Federal gift tax purposes, the value of gifts made to certain qualified public and charitable organizations during the year is subtracted from the value of the taxpayer's total gifts for the year.[161] Therefore, in general, the effect of the charitable deductions for estate and gift tax purposes is to remove the value of charitable transfers from the estate or gift tax base, such that these transfers escape estate or gift taxation.

The basic requirements for a deductible charitable contribution for estate or gift tax purposes generally are the same as the requirements a deductible charitable contribution for income tax purposes. For example, as with the income tax, to qualify for an estate or gift tax charitable deduction the contribution must be made with donative intent and must be made to an eligible donee. The lists of eligible donees for estate and gift tax purposes also largely are coextensive with the list of eligible donees for income tax purposes, with a few differences discussed above.[162]

In contrast to the income tax charitable deduction, there are no percentage limits on the deductibility of a charitable contribution for estate or gift tax purposes. The amount of the deduction also does not differ based on the type of donee organization (*e.g.*, a public charity versus a nonoperating private foundation) or the type of property contributed (*e.g.*, ordinary income property versus capital gain property). For estate tax purposes, however, the deduction generally is limited to the value of the property transferred to charity that is required to be included in the decedent's gross estate.[163]

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[158] Sec. 170(o)(1).

[159] Secs. 2055 (estate tax) and 2522 (gift tax).

[160] Sec. 2055(a).

[161] Sec. 2522(a).

[162] See secs. 170(c), 2055(a), and 2522(a).

[163] Sec. 2055(d).

Exclusion from Gross Income for Distributions from Individual Retirement Arrangements ("IRAs") for Charitable Purposes

A temporary rule provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions made in taxable years beginning before January 1, 2014.[164] The exclusion from gross income may not exceed $100,000 per taxpayer per taxable year.[165]

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than a supporting organization or a donor advised fund). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½ and only to the extent the distribution would be includible in gross income (without regard to this provision).[166]

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under section 170.

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[164] Sec. 408(d)(8). The exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

[165] Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

[166] If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

B. Present Law: Debt, Equity and Capital

1. Background comparing debt and equity

Business enterprises and their investors have business reasons to structure capital investment as either debt or equity. For example, investors may prefer varying levels of risk. Investors may seek different levels of priority in the event of bankruptcy of the business. Businesses can issue interests to investors that have varying levels of control over the enterprise and degrees of participation in profitability or growth of the enterprise.

The tax law generally contains no fixed definition of debt or equity. Taxpayers have considerable flexibility to design instruments treated as either debt or equity but which blend features traditionally associated with both.

The Federal income tax treatment of debt and of equity creates incentives to utilize one or the other depending on the tax characteristics of the issuer and of the particular investor. In general, a corporate issuer is not subject to corporate tax on amounts that it deducts as interest on debt. By contrast, dividends, which are not deductible by the payor, come out of after-tax income of the corporation.

Debt instruments can permit the accrual of the interest deduction along with the inclusion in income by the holder at a time prior to the payment of cash. Interest income may be taxed at a higher rate to a taxable holder than the holder's dividends or capital gains attributable to corporate retained earnings (to which lower tax rates currently apply). However, some forms of debt investments are not subject to U.S. tax or are taxed at reduced rates in the hands of a tax-exempt or foreign investor. A number of special rules in the Code are designed to limit the tax benefits that can be obtained from interest deductions to protect the corporate tax base.

To the extent that debt finances assets that produce tax-exempt or otherwise tax-favored income, the interest deduction is available to offset other income taxed at higher rates. The resulting tax arbitrage can shelter otherwise taxable income. A number of special rules in the Code are directed at limiting this effect.

In addition to the tax benefits of interest deductibility, debt permits owners of business or investment assets to extract cash or to obtain a higher basis in the leveraged asset without an additional equity investment. A higher basis in a leveraged asset that is depreciable, for example, can increase depreciation deductions. This effect may in some situations create an incentive for a business to borrow.

In the event of financial difficulty, the discharge or restructuring of debt can cause the issuer to recognize discharge of indebtedness income or alternatively, gain with respect to the satisfaction of nonrecourse indebtedness for less than the outstanding amount. The income tax treatment of debt discharge depends on whether the debt is recourse or nonrecourse, the nature of the borrower's assets and of the borrowing, and the circumstances of the restructuring or discharge. In a number of instances, no current income is recognized, though tax attributes such as net operating losses, credits, or the basis of assets may be reduced. By contrast, the failure to pay dividends or return an equity investment in full does not cause income or gain to be recognized by the issuer.

In classifying an instrument as debt or equity, many factors have been applied by courts. In general, a debt instrument requires a fixed obligation to pay a certain amount at a specified date. Debt instruments provide for remedies including priorities in bankruptcy in the event of default. However, an instrument designated and respected as debt for tax purposes might have features that make it less likely to cause bankruptcy in the event of a downturn − for example, a delayed period before payment is due, the ability to miss scheduled payments over a long period of time before default occurs, the ability to satisfy required payments with instruments other than cash, thin capitalization of the issuer, or ownership of the debt by equity owners who may be willing to modify its terms rather than cause bankruptcy. Conversely, an instrument designated and respected as equity for tax purposes may have features that are more economically burdensome to the issuer, such as significantly increased dividend payment requirements after a specified period, puts and calls having the effect of requiring a cash redemption by a specified date, or provisions giving the holders certain corporate governance rights in the event scheduled payments are not made.

Equity can be beneficial for tax purposes in certain cases. Although corporate distributions and sales of corporate stock subject the holder to tax in addition to any tax paid by the corporation, reduced tax rates apply to holders with respect to such distributions or gain. Dividends on corporate equity are largely excludable by corporate holders (currently resulting in a maximum 10.5-percent tax rate under the 70-percent dividends received deduction). For individual shareholders, both dividends and capital gains on the sale of corporate stock are generally subject to a maximum 20 percent statutory rate (compared to the top individual rate of 39.6 percent).[167] The present value of the shareholder-level tax on corporate earnings may be reduced to the extent earnings are retained and to the extent shareholders do not sell their stock. This second level of tax and may be eliminated entirely to the extent non-dividend-paying stock is held until the death of the owner. Receipt of equity also permits tax-free business combinations and distributions, both in the case of corporations and partnerships.

The treatment of an instrument for purposes of financial reporting, for regulatory capital purposes in a regulated industry (such as an insurance or banking), for ratings agency purposes, and under foreign tax and nontax laws, may differ from its Federal income tax treatment. These differences may result in more favorable overall business treatment when the benefits of debt or of equity for a Federal income tax purpose are combined with the benefits of a different treatment for another purpose.

[167] An additional 3.8 percent tax may be imposed on net investment income under section 1411.

2. General rules for issuers and holders of debt and equity

Issuer Treatment of Debt and Equity

In general

Interest and dividend payments

Interest paid or accrued by a business is generally deductible, subject to a number of limitations.[168] By contrast, dividends or other returns to equity are not deductible.

Timing of interest deduction

Interest generally is deducted as it is paid or accrues. However, interest can be deducted in advance of actual payment or other accrual under the terms of the instrument when the amount to be paid at the maturity of a debt instrument exceeds the issue price by more than a *de minimis* amount. In such cases, a portion of the amount to be paid at maturity is treated as interest accruing on a constant yield basis over the life of the instrument and is thus deducted in advance of actual payment.[169] Such interest is referred to as original issue discount ("OID").

Principal payments and return of equity capital

Principal payments on business debt are not generally deductible.[170] The return of capital to investors in an equity investment likewise is not deductible.

Receipt of cash from debt or equity investors

The issuance of a debt or equity instrument for cash is not a taxable event to the issuer.

Basis of assets purchased with debt or equity

Purchased assets generally have a cost basis for purposes of determining deprecation or gain or loss on sale, regardless of whether the purchase was financed with debt (including nonrecourse debt) or equity.

Effect of entity level debt on partnership and S corporation equity holders

Equity investors in a partnership or an S corporation[171] can deduct their allocable share of partnership deductions (including depreciation, interest, or loss, for example.) only to the extent

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[168] Sec. 163(a). Some of these limitations are discussed below.

[169] Secs. 1273-1275.

[170] There is an exception for certain debt incurred through a leveraged employee stock ownership plan ("ESOP").

the basis of their interest in the partnership or S corporation.[172] A partner's share of entity level debt is included in the partner's basis in his partnership interest. An S corporation shareholder does not include entity level debt in his S corporation stock basis. However, the S corporation shareholder may deduct losses to the extent of his basis in stock and his basis in debt that the corporation owes to him.

Nonpayments on equity compared to discharge or restructuring of indebtedness

If dividends are not paid on equity, or the capital contributed by an equity holder is not returned, there is generally no taxable income, gain, or other consequence to the issuer.[173]

The effects to the issuer if debt is modified, cancelled, or repurchased depend upon the type of debt, the nature of the holder, and whether or not the debt (or property given in exchange for it) is traded on an established securities market. If debt is cancelled, modified, or repurchased, the borrower generally realizes income from the discharge of indebtedness. Exceptions to this income inclusion are provided for bankruptcy and insolvency, for other situations including seller financing of purchased property, qualified farm indebtedness, qualified real property business indebtedness, and contributions of debt by an equity holder. The exceptions usually require the taxpayer to reduce the basis of property, or to reduce tax attributes such as net operating losses.[174] If nonrecourse debt is satisfied by foreclosure on the assets securing the debt, the borrower generally realizes gain from the disposition of the assets for the amount of the debt (even if the assets are not worth that amount).[175]

Recourse indebtedness

If a taxpayer's recourse debt is discharged, the taxpayer generally recognizes income from the discharge of indebtedness at that time.[176] A satisfaction of the debt with property worth less than the debt,[177] or a repurchase of debt for less than its face amount by the taxpayer or a

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[171] An S corporation is a corporation that has only one class of stock, has no more than 100 shareholders (after applying attribution rules), meets specific other requirements, and makes an election enabling its income and deductions to pass through to its shareholders without entity level tax. Sec. 1371 *et seq*.

[172] Other limitations on a partner's or S corporation shareholder's deductions also can apply, such as the limitation on passive activity losses (sec. 469), or the at-risk limitation (sec. 465).

[173] Under certain circumstances an additional tax at the maximum individual rate on dividends (in addition to the corporate income tax) applies to certain unreasonably accumulated income and to certain undistributed income of a closely held corporation whose income is largely passive. Secs. 531-537 and secs. 541-547.

[174] Sec. 108. The rules relating to debt cancellation are discussed more fully at Part III.B. 2.

[175] *Commissioner v. Tufts*, 461 U.S. 300 (1983); *cf., Crane v. Commissioner*, 331 U.S. 1 (1947).

[176] Sec. 108.

[177] For example, if a creditor contributes its debt to a corporation and receives corporate stock in exchange, the corporation generally recognizes cancellation of indebtedness income to the extent the value of the stock given is less than the amount of the debt cancelled. However, if the debt was held by a person that was also a shareholder,

related party, is treated as a discharge of the taxpayer's debt to the extent of the difference between the outstanding debt and (generally) the value of the property.[178]

A significant modification of a debt instrument is treated as the disposition of the old instrument in exchange for the new instrument.[179] Such modifications include a change in the obligor, a change in term or interest rate; a change in principal amount, and certain modifications of security. The modification of a debt instrument can thus cause the issuer to recognize discharge of indebtedness income, measured by the difference between the adjusted issue price of the old debt and the fair market value (or other applicable issue price) of the new debt.[180] If the debt instrument is publicly traded or is issued in exchange for property (including other debt) that is publicly traded, then the issue price of the new debt is deemed to be the fair market value of the debt or other property that is publicly traded. [181] If neither the old nor the new debt instrument is traded on an established securities market the issue price of the new debt is generally the stated principal amount unless there is inadequate stated interest (i.e., interest less than the Treasury rate for an instrument of comparable term).[182] Thus, in such traded situations, discharge of indebtedness income is likely to be recognized if troubled debt is modified or satisfied with other debt instruments. However, in private situations there may be no discharge of indebtedness income.

In 2008, special temporary rules were enacted allowing any taxpayer that experiences discharge of indebtedness income arising from the reacquisition of its debt (including modifications treated as a reacquisition) to defer including that income for a period of years and then recognize the income ratably over a number of subsequent years.[183] These rules applied to

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the debt may be considered contributed in a nontaxable contribution to capital, not creating discharge of indebtedness income.

[178] Sec. 249.

[179] Treas. Reg. sec. 1.1001-3.

[180] The discharge of indebtedness income is taken into income at the time of the exchange. The new debt may be deemed to be issued with original issue discount (to the extent the amount payable at maturity exceeds the issue price) that the issuer can deduct, which can offset the amount of debt discharge income, but the deductions occur in the future over the period of the new debt, while the income is recognized immediately.

[181] Thus, if a distressed debt instrument is modified and the transaction is treated as an exchange of the old instrument for the new one, the debtor can experience discharge of indebtedness income in the amount of the difference between the adjusted issue price of the old debt and its fair market value at the time of the modification.

[182] In certain "potentially abusive" cases, the principal amount of debt given in exchange for other property (including other debt) is the fair market value of the property exchanged.

[183] Sec. 108(i).

any debt issued by a corporate taxpayer and to debt issued by any other taxpayer in connection with the conduct of trade or business. They expired at the end of 2010.[184]

Special rules allow a taxpayer not to recognize discharge of indebtedness income if the taxpayer is in bankruptcy or is insolvent. These rules permit such taxpayers to reduce net operating loss carryovers, depreciable asset basis, and other tax attributes that would provide tax benefits in the future, in lieu of recognizing current income from the discharge of indebtedness. The rules differ depending on whether the issuer is insolvent or is in a bankruptcy or similar proceeding.

If the discharge of indebtedness occurs in a Title 11 bankruptcy case, the full amount of any debt discharged is excluded from income. If the taxpayer is insolvent, cancellation of debt income is excludable only to the extent of the insolvency. In either case, if the tax attributes subject to reduction are insufficient to cover the amount of the discharge, there is no inclusion of debt discharge income for the excess. In the case of an entity that is taxed as a partnership, the determinations whether the discharge occurs in a Title 11 bankruptcy case, whether the taxpayer is insolvent, and the reduction of tax attributes, all occur at the partner level.

Tax attributes are generally reduced in the following order: (1) net operating losses, (2) general business credits, (3) minimum tax credits, (4) capital loss carryovers, (5) basis reduction of property, (6) passive activity loss and credit carryovers, and (7) foreign tax credits. A taxpayer may elect to apply the reduction first against the basis of depreciable property.

Other special rules allow a taxpayer that is not in bankruptcy or insolvent to exclude discharge of indebtedness income and instead reduce the basis of certain real property. These rules apply only for discharge of certain qualified real estate indebtedness or qualified farm indebtedness. The rules relating to qualified real estate indebtedness are available only to noncorporate taxpayers.

Purchase money financing

If debt that is discharged was seller-financing for a purchase of property by the debtor, and if the debtor is not insolvent or in a bankruptcy proceeding, then instead of income from the discharge of indebtedness, the debtor-purchaser has a purchase price reduction (which reduces the basis of the property acquired).

Nonrecourse indebtedness

Nonrecourse debt is subject to different rules than recourse debt.[185] Because the taxpayer is not personally liable on the debt, there is no cancellation of indebtedness income. However, if

[184] Pub. L. No.111-5, sec. 1231. Section 1232 gives the Treasury Department authority to suspend the AHYDO rules or modify the rate for determining what is an AHYDO in certain distressed debt capital market conditions.

[185] The distinction between recourse and nonrecourse debt may be less obvious than it would appear. Recourse debt might be issued by an entity that has limited liability and limited assets, while nonrecourse debt might be oversecured.

the creditor forecloses or otherwise takes the property securing the debt, the borrower treats the transaction as a sale of the property for a price equal to the outstanding indebtedness (even if the property securing the debt is worth less than the debt at the time of foreclosure).[186] Such a transaction generally produces capital gain (rather than ordinary income) to the debtor.

Holder Treatment of Debt and Equity

Current income and sales of interests

Taxable investors

Interest on debt is taxed to a taxable individual or corporate holder at the ordinary income tax rate of the holder.[187] Dividends paid by a taxable C corporation,[188] are generally taxed to a taxable individual shareholder at a maximum rate of 20 percent. Such dividends are generally taxed to a taxable C corporation shareholder at a maximum rate of 10.5 percent (or less, depending on the percentage ownership the corporate shareholder has in the issuing corporation).[189] Gain on the sale of an equity interest in a C corporation or in an S corporation is generally capital gain. If the stock has been held for at least one year, such gain is generally taxable to a taxable individual shareholder at a maximum rate of 20 percent. Gain on the sale of C corporation stock[190] is taxed to a taxable corporate shareholder[191] at regular corporate rates (generally 35 percent). Gain on the sale of an equity interest in a partnership is generally also

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[186] *Commissioner v. Tufts*, 461 U.S. 300 (1983); *cf., Crane v. Commissioner*, 331 U.S. 1 (1947).

[187] An additional 3.8 percent tax may be imposed on net investment income under section 1411.

[188] A C corporation is defined by reference to subchapter C of the Code (tax rules relating to corporations and shareholders) and is taxable as a separate entity with no deduction for dividends or other equity distributions. For purposes of the discussion in this document,, such corporations are distinguished from certain corporations that meet specific tests relating to organization, functions, assets, and income types can deduct dividends and certain other equity distributions to shareholders, (e.g., real estate investment trusts (REITs) or regulated investment companies (RICs)). A C corporation is also distinguished from an S corporation, governed by the additional rules of subchapter S. An S corporation is a corporation that has only one class of stock, has no more than 100 shareholders (after applying attribution rules), meets other specific requirements, and makes an election enabling its income and deductions to pass through to its shareholders without entity level tax. Sec. 1371 et seq.

[189] The lower rate on dividends received by a corporate shareholder results from the corporate "dividends received deduction," which is generally 70 percent of the dividend received if the shareholder owns below 20 percent of the issuer, 80 percent of the dividend received if the shareholder owns at least 20 percent and less than 80 percent of the issuer, and 100 percent of the dividend if the shareholder owns 80 percent of more of the issuer (sec. 243). A corporation subject to the maximum 35 percent corporate tax rate and entitled to deduction 70 percent of a dividend would pay a maximum tax on the dividend of 10.5 percent (the 30 percent of the dividend that is taxable, multiplied by the 35 percent tax rate).

[190] A corporate shareholder cannot own S corporation stock.

[191] A C corporation is not an eligible S corporation shareholder and therefore cannot own S corporation stock.

capital gain of the partner, except for amounts attributable to unrealized receivables and inventory items of the partnership, which are taxable as ordinary income.[192]

Interest is generally taxable when paid or accrued. Interest generally is includable in income, and thus taxable, before any cash payment if the original issue discount rules apply. Dividends are generally not taxable until paid. However, in limited circumstances certain preferred stock dividends may be accrued under rules similar to the rules for debt. Also, a shareholder may be treated as having received a dividend if his percentage stock ownership increases as a result of the payment of dividends to other shareholders.[193]

Tax-exempt investors

A tax-exempt investor (for example, a university endowment fund or a pension plan investor) is generally not taxed on investment interest, subject to certain unrelated business income tax (UBTI) rules for debt-financed income.[194] This is true whether the debt is issued by a C corporation or by any other entity.

Tax-exempt investors also are generally not subject to tax on sale of C corporation stock, unless the stock investment is debt-financed.

However, tax-exempt equity investors in a partnership are taxed as engaged in an unrelated trade or business on their distributive share of partnership income from such a business, as if they had conducted the business directly. And tax-exempt equity investors in an S corporation (other than an ESOP investor) are taxed on their entire share of S corporation income or gain on sale of the stock.[195]

Foreign investors

Debt interests in U.S. entities

Although U.S.-source interest paid to a foreign investor is generally subject to a 30-percent gross basis withholding tax, various exceptions exist in the Code and in bilateral income tax treaties.[196] Interest is generally derived from U.S. sources if it is paid by the United States or

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[192] Sec. 751.

[193] Sec. 305(c). Certain situations in which some shareholders receive cash and others experience an increase in their percentage ownership can also cause both groups of shareholders to be treated as receiving a dividend under that section.

[194] Secs. 512, 514.

[195] Sec. 512(b).

[196] Where a foreign investor is engaged in a U.S. trade or business, any U.S. source interest income or U.S. source dividend income (see "Equity interest in U.S. Entities" below) derived from assets used in or held for use in the conduct of the U.S. trade or business where the activities of the trade or business were material factor in the realization of such income will be treated as effectively connected with that U.S. trade or business. Sec. 864(a)(2).

any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a noncorporate resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[197] For this purpose, a noncorporate resident includes a domestic partnership which at any time during the year was engaged in a U.S. trade or business.[198] Additionally, interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[199]

Statutory exceptions to this general rule apply for interest on bank deposits as well as portfolio interest. Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source income but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[200] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[201] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[202]

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from U.S. withholding tax.[203] For obligations issued before March 19, 2012, the term "portfolio interest" means 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, as well as interest paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B). Portfolio interest,

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[197] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1). However, special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions. Sec. 861(a)(1). Prior to January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. This provision was generally repealed for tax years beginning after December 31, 2010.

[198] Treas. Reg. sec. 1.861-2(a)(2).

[199] Sec. 884(f)(1).

[200] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[201] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[202] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[203] Secs. 871(h), 881(c). In 1984, to facilitate access to the global market for U.S. dollar-denominated debt obligations, Congress repealed the withholding tax on portfolio interest paid on debt obligations issued by U.S. persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

however, does not include interest received by a 10-percent shareholder,[204] certain contingent interest,[205] interest received by a controlled foreign corporation from a related person,[206] 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.[207]

For obligations issued after March 18, 2012, the term "portfolio interest" no longer includes interest paid with respect to an obligation not in registered form. This narrowing of the scope of the portfolio interest exemption is a result of the repeal of the exception to the registration requirements for foreign targeted securities in 2010, effective for obligations issued two years after enactment.[208]

U.S.-source interest payments that do not qualify for a statutory exemption from the 30-percent withholding tax often are exempt from withholding under U.S. bilateral income tax treaties. Many treaties, including, for example, those with Canada, Germany, and the United Kingdom, broadly eliminate the withholding tax on U.S.-source interest payments. The result is that large volumes of interest payments are exempt from withholding under the Code or a treaty.

Equity interests in U.S. entities

A foreign equity investor's receipt of U.S.-source dividend income from a U.S. domestic corporation is generally subject to a 30-percent gross basis withholding tax. Dividend income is generally sourced by reference to the payor's place of incorporation such that dividends paid by a domestic corporation are generally treated as entirely U.S.-source income.[209] As with interest, the 30-percent withholding tax on dividends received by foreign investors may be reduced or eliminated under U.S. bilateral income tax treaties. In general, the dividend withholding tax rates in treaties vary based on the percentage of stock of the dividend-paying company owned by the recipient of the dividend. Treaties typically provide lower withholding tax rates (five percent, for example) at ownership levels of ten percent and greater. Twelve treaties, including those with Germany, Japan, and the United Kingdom, eliminate the withholding tax on dividends in circumstances in which, among other requirements, the foreign treaty resident is a company that owns at least 80 percent (in the case of Japan, 50 percent) of the U.S. corporation paying the dividend.

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[204] Sec. 871(h)(3).

[205] Sec. 871(h)(4).

[206] Sec. 881(c)(3)(C).

[207] Sec. 881(c)(3)(A).

[208] Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

[209] Secs. 861(a)(2), 862(a)(2).

Foreign investors also are not generally subject to tax on the sale of C corporation stock.[210]

In contrast, a foreign equity investor in a partnership is taxed on its distributable share of income effectively connected with the conduct of a U.S. trade or business, as if it had conducted that business directly. S corporations are not permitted to have foreign investors.

Treatment if investment becomes worthless

A taxable holder of either debt or equity held as an investment generally recognizes a capital loss if the instrument is sold to an unrelated party at a loss.[211] Capital losses can generally offset only capital gains; however, an individual may deduct up to $3,000 per year of capital loss against ordinary income.

A taxable holder of investment equity or debt also generally realizes a capital loss if the instrument becomes worthless. Certain other transactions, such as liquidating a subsidiary,[212] can permit recognition of a stock loss without a sale to an unrelated party.

In certain circumstances, an individual holder of debt that is not a security may take an ordinary bad debt loss.[213]

Acquisitions and Dispositions of Debt and Equity

The Code permits certain corporate acquisitions and dispositions to occur without recognition of gain or loss, generally so long as only equity interests are received or any securities received do not exceed the amount surrendered.[214] Similarly, the Code permits certain contributions and distributions of property to and from partnerships without tax if made with respect to an equity interest.[215]

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[210] Secs. 871 and 881, applicable to income not connected with a U.S. business. The exemption does not apply to a foreign individual who is present in the U.S. for 183 days or more during the taxable year. Foreign investors may be subject to tax if the stock is a U.S. real property interest under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). Sec. 897.

[211] Up to $50,000 of loss on certain small business company stock ($100,000 for a couple filing a joint return) can be deducted as an ordinary loss. Sec. 1244.

[212] See Sec. 267(a)(1), second sentence.

[213] Sec. 166.

[214] Secs. 351-368 and sec. 1032.

[215] Secs. 721 and 731.

A transfer of property to a corporation or partnership in exchange for debt of the entity is generally treated as a sale of the property.[216] Gain or loss is recognized, except that loss may be deferred if the transfer is to a related party.[217]

3. Definition of debt and equity

Distinguishing Debt from Equity

In general

The characterization of an instrument as debt or equity for Federal income tax purposes is generally determined by the substance of the investor's investment. An instrument's characterization depends upon the terms of the instrument and all the surrounding facts and circumstances analyzed in terms of economic and practical realities. Neither the form of the instrument nor the taxpayer's characterization of the interest is necessarily determinative of the instrument's treatment for Federal income tax purposes. Nonetheless, between the extremes of instruments that are clearly debt or clearly equity, taxpayers have some latitude to structure instruments incorporating both debt- and equity-like features (commonly referred to as "hybrid securities").[218]

There is currently no definition in the Code or Treasury regulations that can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Moreover, the IRS will ordinarily not provide individual taxpayers guidance on whether an interest in a corporation is debt or equity for tax purposes because, in its view, the issue is primarily one of fact.[219]

In the absence of statutory or regulatory standards, a substantial body of Federal common law is the principal source of guidance for distinguishing debt and equity. Courts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis, the primary goal of which is to determine whether, in both substance and form, an instrument represents risk capital entirely subject to the fortunes of the venture (equity),[220] or an unqualified

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[216] Sec. 1001. Special rules may apply if the transfer is considered part of a larger transaction such as an otherwise tax-free corporate reorganization.

[217] Secs. 267 and 707.

[218] See *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 123 (2d Cir. 1956) (noting that "[t]he vast majority of these cases have involved 'hybrid securities' - instruments which had some of the characteristics of a conventional debt issue and some of the characteristics of a conventional equity issue.").

[219] Rev. Proc. 2011-3, sec. 4.02(1), 2011-1 I.R.B. 111. The IRS has identified factors to weigh in determining whether a particular instrument should be treated as debt or equity. See, *e.g.*, Notice 94-47, 1994-1 C.B. 357.

[220] See, *e.g.*, *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943) (noting that "[t]he essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit."); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960); *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d

promise to pay a sum certain on a specified date with fixed interest (debt).[221] The determination of whether an interest constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case.[222]

Courts have created differing (though generally similar) lists of factors[223] to distinguish debt from equity with no one factor controlling or more important than any other.[224] One commentator provides a list of thirty factors along with the Circuit courts that have considered these factors.[225] Another commentator groups the factors discussed in the cases into four categories: (1) those involving the formal rights and remedies of the parties; (2) those bearing on the genuineness of the alleged intention to create a debtor-creditor relationship; (3) those bearing on the reasonableness or economic reality of that intention (the risk element); and (4) those which are merely rhetorical expressions of a result, having no proper evidentiary weight in themselves.[226]

11, 12 (2d Cir. 1935) (noting that that the distinction between the shareholder and the creditor is that "[t]he shareholder is an adventurer in the corporate business; he takes the risk and profits from success [while] [t]he creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.").

[221] *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (noting that debt involves "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof."); sec. 385(b)(1) ("a written unconditional promise to pay on demand or an a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest"); Treas. Reg. sec. 1.165-5(a)(3) (defines security as an evidence of indebtedness to pay a fixed or determinable sum of money); sec. 1361(c)(5)(B) (straight-debt safe harbor for subchapter S purposes).

[222] *John Kelley Co. v. Commissioner*, 326 U.S. 489 (1943) (stating "[t]here is no one characteristic, not even the exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.").

[223] See, e.g., *Fin Hay Realty Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) (sixteen factors); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (thirteen factors); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986) (eleven factors); *United States v. Uneco Inc.*, 532 F.2d 1204 (8th Cir. 1976) (ten factors).

[224] *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969) (noting that "[t]he object of the inquiry is not to count factors, but to evaluate them"); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (noting that the factors are not of equal significance and that no one factor is controlling).

[225] Christensen, "The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion," 74 *University of Chicago Law Review* 1309, 1313 (2007).

[226] Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax Law Review* 369, 411-412 (1971). According to a study of 126 Tax Court opinions issued from 1955 to 1987, seven factors were found to be conclusive of debt classification 97 percent of the time. Robertson, "Daughtrey & Burckel, Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987," 47 *Tax Notes* 707 (1990).

Some commonly cited factors considered, among others, are:

1. whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future;

2. whether the holder possesses the right to enforce the payment of principal and interest;

3. whether there is subordination to, or preference over, any indebtedness of the issuer, including general creditors;

4. the intent of the parties, including the name given the instrument by the parties and its treatment for nontax purposes including financial accounting, regulatory, and rating agency purposes;

5. the issuer's debt to equity ratio;

6. whether the instrument holder is at risk of loss or has the opportunity to participate in future profits;

7. whether the instrument provides the holder the right to participate in the management of the issuer;

8. the availability and terms of other credit sources;

9. the independence (or identity) between holders of equity and the holders of the instrument in question;

10. whether there are requirements for collateral or other security to ensure the payment of interest and principal; and

11. the holder's expectation of repayment.

Regulatory authority pursuant to section 385

Section 385 authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation should be characterized as debt or equity (or as in part debt and in part equity) for Federal income tax purposes. Section 385(b) lists five factors which "may" be included in regulations prescribed under the section as relevant to the debt/equity analysis. Section 385(b) lists the factors as:

1. whether there is an unconditional written promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;

2. whether there is subordination to or preference over any indebtedness of the corporation;

3. the corporation's debt to equity ratio;

4. whether the interest is convertible into stock of the corporation; and

5. the relationship between the holdings of stock in the corporation and holdings of the interest in question.

As detailed below, regulations under section 385 were promulgated but withdrawn without ever having taken effect. The withdrawn regulations are not legally binding on the IRS or taxpayers.

Section 385(c) provides that an issuer's characterization of an instrument (at the time of issuance) is binding on the issuer and any holder, but not the Secretary. However, the holder of an instrument may treat an instrument differently than the issuer provided the holder discloses the inconsistent treatment on his return.

Legislative background of section 385

Section 385 was enacted by the Tax Reform Act of 1969.[227] The Senate Finance Committee noted that:

"In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations."[228]

The Treasury promulgated proposed regulations under section 385 in March of 1980[229] and final regulations on December 31, 1980, with an effective date of April 30, 1981. The

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[227] Pub. L. No. 91-172.

[228] S. Rep. No. 91-552 (November 21, 1969). The Senate Finance Committee previously considered whether to define debt and equity in the context of creating the Internal Revenue Code of 1954. At that time the issue was whether the Senate should adopt the House of Representatives' draft version of the Code which defined participating stock (common stock) and nonparticipating stock (preferred stock) and defined the term security. The Senate Finance Committee ultimately recommended that these definitions be dropped, noting:

> Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly, your committee has returned to the use of the terms "stock," "common stock," "securities," etc., and, as is the case under existing law, has not attempted to define them in the statute. S. Rep. No. 1622, 83 Cong., 2d Sess. 42 (1954).

[229] 45 F.R. 18957.

effective date was extended twice.[230] The Treasury promulgated proposed amendments to the regulations in 1982.[231] The effective date of the proposed amendments, and the final regulations, were again postponed.[232] The final regulations were withdrawn in 1983 without ever having taken effect.[233]

Section 385 was amended by the Omnibus Budget Reconciliation Act of 1989[234] to specifically add authority for the Secretary to treat an interest in a corporation as part stock and part debt.[235] In 1992, section 385 was amended to add section 385(c) regarding the effect of an issuer's classification.[236]

4. Rules to address stripping of U.S. corporate tax base in the case of nontaxed holders

A taxable corporation may reduce its Federal income tax through the payment of deductible amounts such as interest, rents, royalties, premiums, management fees to an affiliate not subject to Federal income tax. Sheltering or offsetting income otherwise subject to Federal income tax in this manner is known as "earnings stripping." Several provisions of present law limit taxpayers' ability to strip earnings. Following is a brief description of certain rules designed to limit the ability of corporations to strip earnings using payments of interest.

Earnings Stripping

Present law

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the safe harbor ratio); and the payor's net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions

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[230] T.D. 7747, 45 F.R. 86438; T.D. 7774, 46 F.R. 24945; T.D. 7801, 47 F.R. 147.

[231] See 47 F.R. 164.

[232] T.D. 7822, 47 F.R. 28915.

[233] T.D. 7920, 48 F.R. 50711. One commentator suggests that the regulations were not finalized because tax planners could design instruments contained all of the essential features of equity but which qualify as debt under the regulations. As an example, he noted that an instrument would be classified as debt if its debt features accounted for more than half of its value and that as a result of this rule, hybrid instruments such as adjustable rate convertible notes began appearing that provided for guaranteed payments having a present value just greater than half of the issue price, variable payments tied to the issuer's common-stock dividends, and an option to convert these instruments into shares of the issuer's stock. Adam O. Emmerich, "Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation," 52 *University of Chicago Law Review* 118, 129-131 (1985).

[234] Pub. L. No. 101-239.

[235] Section 7208(a)(2) of Pub. L. No. 101-239 provides that the authority granted to bifurcate an interest in a corporation may not be applied retroactively.

[236] Energy Policy Act of 1992, Pub. L. No. 102-486.

for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;[237] (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.[238] Interest amounts disallowed under these rules can be carried forward indefinitely.[239] 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.[240]

The operation of these rules is illustrated by the following example. ForCo, a corporation organized in country A, wholly owns USCo, a corporation organized in the United States. ForCo's investment in USCo stock totals $6.5 million. In addition, USCo has borrowed $8 million from ForCo and $5 million from Bank, an unrelated bank. In 2010, USCo's first year of operation, USCo's adjusted taxable income is $1 million (none of which is from interest income), and it also pays $400,000 of interest to ForCo and $300,000 of interest to the unrelated bank. Under the U.S.-country A income tax treaty, no tax is owed to the United States on the interest payments made by USCo to ForCo.

USCo has a 2:1 debt-to-equity ratio (total borrowings of $13 million ($8 million + $5 million) and total equity of $6.5 million), so USCo's deduction for the $700,000 ($400,000 + $300,000) of interest it paid may be limited.

USCo's disqualified interest is $400,000 (the amount of interest paid to a related party on which no Federal income tax is imposed).

USCo's excess interest expense is $200,000 ($700,000 - ($1 million x 50%)).

Accordingly, USCo may deduct only $500,000 ($700,000 - $200,000) for interest expense in year 2010.

The $200,000 of excess interest expense may be carried forward and deducted in a subsequent tax year with excess limitation.

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[237] 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).

[238] Sec. 163(j)(3).

[239] Sec. 163(j)(1)(B).

[240] Sec. 163(j)(2)(B)(ii).

Legislative background

Section 163(j) was enacted in 1989 in response to Congressional concerns over earnings stripping.[241] Congress believed it was "appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base."[242]

In 1993, the earnings stripping rules were amended so that they applied to interest paid on unrelated party loans if guaranteed by a related party under certain circumstances.[243] Congress made this change because it was concerned about the distinction made under the existing earnings stripping rules between the situation in which unrelated creditors all lend to the parent of a group, which in turn lends to the U.S. subsidiary, and the situation in which the creditors lend directly to the U.S. subsidiary with a guarantee from the parent.[244] The existing rules applied to the first situation but not the second situation, even though the "same 'excess' interest deductions, and the same resultant 'shifting' of net income out of U.S. taxing jurisdiction, is obtainable through borrowing by U.S. corporations on [the parent's] credit."[245]

The definition of disqualified interest was expanded in 1999 to include interest paid or accrued by a taxable REIT subsidiary to a related REIT.[246]

In 2006, the earnings stripping rules were modified to apply to corporate owners of partnership interests.[247] Specifically, the modifications provided that for purposes of applying the earnings stripping rules when a corporation owns an interest in a partnership, (1) the corporation's share of partnership liabilities are treated as liabilities of the corporation, and (2) the corporation's distributive share of interest income and interest expense of the partnership is treated as interest income or interest expense, respectively, of the corporation. Treasury was also granted expanded regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense.

The American Jobs Creation Act of 2004 required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping

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[241] Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7210.

[242] H.R. Rep. No. 101-247, p. 1241 (1989).

[243] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13228.

[244] H.R. Rep. No. 103-111, p. 683 (1993).

[245] *Ibid.,* p. 682.

[246] Tax Relief Extension Act of 1999, Pub. L. No. 106-170, sec. 544. Technical corrections were also made in 1996 and 2005. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, secs. 1703(n)(4), 1704(f)(2); Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, sec. 403(a)(15).

[247] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 501 (2006).

provisions of present law, including specific recommendations to improve the provisions of the Code applicable to earnings stripping.[248] The Treasury Department submitted its report to Congress on November 28, 2007.[249] In summary, the report concludes that "[t]here is strong evidence that [inverted corporations][250] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[251] The report also concludes, however, that the evidence that other foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive, and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[252]

Subsequent to its 2007 report on earnings stripping, the Treasury Department created a new tax form, Form 8926 Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information, to collect information related to earnings stripping. Form 8926 must be filed by a corporation (other than an S corporation) if it paid or accrued disqualified interest during the taxable year or had a carryforward of disqualified interest from a previous tax year.

Tax Treatment Of Certain Payments To Controlling Exempt Organizations

Present law

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,[253] such organizations may be subject to the unrelated business income tax (UBIT)[254] on interest and other income received from the organization's controlled

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[248] Pub. L. No. 108-357, sec. 424.

[249] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007). For a detailed discussion of the report, including an analysis of its methodology and conclusions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 259-65.

[250] An "inverted corporation" is a former U.S.-based multinational that restructured to replace a U.S. parent corporation with a new foreign parent for the group. For purposes of the Treasury report, inverted corporations are a subset of foreign-controlled domestic corporations.

[251] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26.

[252] *Ibid.,* pp. 25-26.

[253] Sec. 501(a).

[254] Secs. 511-514. In general, UBIT taxes income derived from a regularly carried on trade or business that is not substantially related to the organization's exempt purposes. Certain categories of income—such as interest, dividends, royalties, and rent—are generally exempt from UBIT. For example, tax-exempt organizations are not taxed on interest income they receive from investments in debt or other obligations.

subsidiaries.[255] Section 512(b)(13) subjects interest income (as well as rent, royalty, and annuity income) to UBIT if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax-exempt).[256]

A special rule relaxes the general rule of section 512(b)(13) for qualifying specified payments made pursuant to a binding written contract that was in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms).[257] The special rule applies to payments received or accrued before January 1, 2012.

Legislative background

Congress enacted section 512(b)(13) as part of the Tax Reform Act of 1969[258] for the purpose of preventing organizations from avoiding taxation through arrangements in which a taxable organization controlled by a tax-exempt organization would make deductible payments of interest, rent, annuities, or royalties to the tax-exempt organization to reduce taxable income.[259] Congress amended section 512(b)(13) in 1997 to broaden the definition of control to capture arrangements using constructive ownership and second-tier subsidiaries.[260]

The Pension Protection Act of 2006 enacted the special rule for qualifying specified payments under section 512(b)(13)(E).[261] The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 extended the special rule to such payments received or accrued before

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[255] Tax-exempt organizations subject to UBIT include those described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2). Organizations liable for UBIT may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

[256] In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

[257] Sec. 512(b)(13)(E). For such payments covered by the special rule, the general inclusion rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (*i.e.*, at arm's length). In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

[258] Pub. L. No. 91-172.

[259] See H.R. Rep. No. 413, 91st Cong., 1st Sess. 49 (1969).

[260] Tax Relief Act of 1997, Pub. L. No. 105-34.

[261] Pub. L. No. 109-280.

January 1, 2009,[262] and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[263] extends the special rule to such payments received or accrued before January 1, 2012.

5. Rules to Address Corporate Base Erosion Without Regard to Holders' Tax Status

Several present-law rules limit interest deductions in circumstances in which it appears a deduction would not be appropriate, for example, because the instrument more closely resembles equity or because deductibility would otherwise allow an inappropriate reduction of the corporate tax base. The inappropriate reduction of the corporate tax base through the use of deductible payments or other planning techniques is commonly referred to a "base erosion." Some limitations on the deductibility of interest expense are linked to whether the recipient of the interest is exempt from Federal tax (*e.g.*, the earnings stripping limitation of section 163(j)) while others consider the timing of the borrower's deduction matches the timing of the lender's corresponding income inclusion (*e.g.*, the interest and OID rules of sections 267(a)(3) and 163(e)(3)). Other interest deduction limitations apply without regard to holder's tax status. Following is a brief description of some of these limitations.

Corporate Equity Reduction Transactions

Present Law

A net operating loss ("NOL") is the amount by which a taxpayer's business deductions exceed its income. In general, an NOL may generally be carried back two years and carried forward 20 years to offset taxable income in such years.[264] NOLs offset taxable income in the order of the taxable years to which the NOLs are carried.[265]

Sections 172(b)(1)(E) and 172(h) limit the NOL carrybacks of a C corporation involved in a corporate equity reduction transaction (a "CERT") to the extent such NOL carryback is attributable to interest deductions allocable to a CERT and is incurred (1) in the taxable year in which the CERT occurs or (2) in either of the two succeeding taxable years. The portion of the corporation's NOL carryback that is limited is the lesser of (a) the corporation's interest expense allocable to the CERT, or (b) the excess of the corporation's interest expense in the loss limitation year over the average of the corporation's interest expense for the three taxable years prior to the CERT taxable year. Any portion of an NOL that cannot be carried back under the provision may be carried forward as otherwise allowed.

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[262] Pub. L. No. 110-343.

[263] Pub. L. No. 111-312.

[264] Sec. 172(b)(1)(A).

[265] Sec. 172(b)(2).

Except to the extent provided in regulations, interest is allocated to a CERT using the "avoided cost" method of allocating interest in lieu of a direct tracing rule.[266] That is, the amount of indebtedness treated as incurred or continued to finance the CERT is based on the amount of interest expense that would have been avoided if the CERT had not been undertaken and the amounts expended for the CERT were used to repay indebtedness.

A corporate equity reduction transaction means either a major stock acquisition or an excess distribution. A major stock acquisition is the acquisition by a corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50 percent or more (by vote or value) of the stock of another corporation.[267] A major stock acquisition does not include a qualified stock purchase to which a section 338 election applies.[268] An excess distribution is the excess of the aggregate distributions and redemptions made by a corporation during the taxable year with respect to its stock (other than certain preferred stock described in section 1504(a)(4)), over the greater of (a) 150 percent of the average of such distributions and redemptions for the preceding three taxable years, or (b) 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year. The amount of distributions and redemptions made by a corporation during a taxable year are reduced by stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation.

A corporation is treated as being involved in a CERT if it is either the acquired or acquiring corporation, or successor thereto (in the case of a major stock acquisition) or the distributing or redeeming corporation, or successor thereto (in the case of an excess distribution).

Legislative Background

The CERT provisions were added to the Code by the Omnibus Budget Reconciliation Act of 1989[269] because Congress believed that the ability of corporations to carry back NOLs created by certain debt-financed transactions is contrary to the purpose of the NOL rules. The NOL carryover rules generally serve the purpose of smoothing swings in taxable income that can result from business cycle fluctuations and unexpected financial reverses. Congress believed that the underlying nature of a corporation is substantially altered by a CERT, and that the interest expense associated with such transaction lacks a sufficient nexus with prior period operations to justify the carryback of NOLs attributable to such expense.[270] The definition of a CERT was expanded by the Omnibus Budget Reconciliation Act of 1990[271] to include the

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[266] Sec. 172(h)(2)(B) (adopting the avoided cost allocation method described in section 263A(f)(2)(A)(ii) and not the direct tracing method described in section 263A(f)(2)(A)(i)).

[267] Secs. 172(h)(3)(A)(i) and 172(h)(3)(B).

[268] Sec. 172(h)(3)(B)(ii). A section 338 election allows taxpayers to treat a qualifying stock acquisitions as an asset acquisition for tax purposes.

[269] Pub. L. No. 101-239.

[270] H.R. Rep. No. 101-247.

[271] Pub. L. No. 101-508.

acquisition of 50 percent or more of the vote or value of the stock of any corporation, regardless of whether the corporation was a member of an affiliated group (unless an election under section 338 were made).

Debt Expected To Be Paid In Equity

Present law

Section 163(l) generally disallows a deduction for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), or equity held by the issuer (or a related party) in any other person.

For this purpose, debt is treated as payable in equity if a substantial amount of the principal or interest is mandatorily convertible or convertible at the issuer's option into such equity. In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of such equity.[272] A debt instrument also is treated as payable in equity if it is part of an arrangement that is reasonably expected to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that the option will be exercised.[273] An exception is provided for debt issued by a dealer in securities (within the meaning of section 475) or a related party which is payable in, or by reference to, equity (not of the issuer or related party) held in its capacity as a dealer in securities.[274]

Application of section 163(l) to an instrument will generally disallow the issuer's interest or OID deductions, but the provision does not alter the treatment of amounts paid or accrued to the holder.[275]

Legislative background

Section 163(l) was enacted by the Taxpayer Relief Act of 1997[276] in response to Congressional concern that corporate taxpayers could issue instruments denominated as debt, but that more closely resembled equity for which an interest deduction is not appropriate.[277]

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[272] Sec. 163(l)(3)(B).

[273] Sec. 163(l)(3)(C).

[274] Sec. 163(l)(5).

[275] See H.R. Conf. Rep. 105-220.

[276] Pub. L. No. 105-34.

The American Jobs Creation Act of 2004[278] expanded the provision to disallow interest deductions on certain corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or any related party) in any other person, but provided for the dealers in securities exception. Prior to AJCA, section 163(l) operated to disallow a deduction with respect to an instrument payable in stock of the issuer or an a related party (using a more than 50 percent ownership test). Expansion of the scope of section 163(l) was prompted, at least in part, by transactions undertaken by Enron Corporation to effectively monetize affiliate stock.[279] For example, in 1995 Enron issued investment unit securities which provided for an amount payable at maturity in stock of a more than 50-percent owned Enron affiliate. In 1999, after the enactment of section 163(l), Enron issued similar investment unit securities with respect to the same corporate affiliate. Enron took the position that section 163(l), however, did not apply because Enron's ownership of the affiliate had decreased below the 50-percent threshold.[280] Congress believed the Enron transactions cast doubt on the rule excluding stock ownership interests of 50-percent or less. Congress believed that eliminating the related party threshold furthered the tax policy objective of similar tax treatment for economically similar transactions.[281]

Applicable High-Yield Discount Obligations

Present law

In general, the issuer of a debt instrument with OID may deduct the portion of such OID equal to the aggregate daily portions of the OID for days during the taxable year.[282] However, in the case of an applicable high-yield discount obligation (an AHYDO) issued by a corporate issuer, (1) no deduction is allowed for the "disqualified portion" of the OID on such obligation, and (2) the remainder of the OID on any such obligation is not allowable as a deduction until paid by the issuer.[283]

An AHYDO is any debt instrument if (1) the maturity date on such instrument is more than five years from the date of issue; (2) the yield to maturity on such instrument exceeds the

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[277] H.R. Rep. No. 105-148.

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

[279] See S. Rep. No. 108-192.

[280] For a discussion of the Enron transactions, see Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, pp. 333-345.

[281] S. Rep. No. 108-192.

[282] Sec. 163(e)(1). For purposes of section 163(e)(1), the daily portion of the original issue discount for any day is determined under section 1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

[283] Sec. 163(e)(5).

sum of (a) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued and (b) five percentage points, and (3) such instrument has significant original issue discount.[284] An instrument is treated as having significant OID if the aggregate amount of interest that would be includible in the gross income of the holder with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and (2) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.[285] The disqualified portion of the OID on an AHYDO is the lesser of (1) the amount of OID with respect to such obligation or (2) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield (*i.e.*, the excess of the yield to maturity on the obligation over the applicable Federal rate plus six percentage points) on such obligation bears to the yield to maturity on such obligation.[286] The term total return means the amount which would have been the original issue discount of the obligation if interest described in section 1273(a)(2) were included in the stated redemption to maturity.[287] A corporate holder treats the disqualified portion of OID as a stock distribution for purposes of the dividend received deduction.[288]

Legislative background

Sections 163(i) and 163(e)(5) were enacted by the Omnibus Budget Reconciliation Act of 1989,[289] following a series of Congressional hearings on corporate leverage. Congress enacted the AHYDO rules because it believed that a portion of the return on certain high-yield OID obligations is similar to a non-deductible distribution of corporate earnings paid with respect to equity rather than a deductible payment of interest.[290]

The American Recovery and Reinvestment Tax Act of 2009 ("ARRA")[291] suspended the deduction denial and deferral rules of section 163(e)(5) for certain obligations issued in debt-for-debt exchanges (including deemed exchanges resulting from a significant modification) after August 31, 2008 and before January 1, 2010. ARRA also provided authority to the Secretary to (1) apply the suspension rule for periods after December 31, 2009, where the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital

[284] Sec. 163(i)(1).

[285] Sec. 163(i)(2).

[286] Sec. 163(e)(5)(C).

[287] Sec. 163(e)(5)(C)(ii).

[288] Sec. 163(e)(5)(B).

[289] Pub. L. No. 101-239.

[290] H.R. Conf. Rep. 101-386 (November 21, 1989).

[291] Pub. L. No. 111-5.

markets, and (2) use a rate that is higher than the applicable Federal rate for purposes of applying section 165(e)(5) for obligations issued after December 31, 2009, in taxable years ending after such date if the Secretary determines that such higher rate is appropriate in light of distressed debt capital market conditions.

Interest on Certain Acquisition Indebtedness

Present law

Section 279 denies a deduction for interest on "corporate acquisition indebtedness." The limitation applies to interest in excess of $5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of stock, or two thirds of the assets, of another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated;[292] (2) the debt carries an equity participation feature[293] (*e.g.*, includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) either the issuer is thinly capitalized (*i.e.*, has a debt-to-equity ratio that exceeds 2 to 1)[294] or projected annual earnings do not exceed three times annual interest costs (paid or incurred).[295]

Legislative background

Section 279 was enacted by the Tax Reform Act of 1969[296] in response to concerns over increased corporate acquisitions and the use of debt for such corporate acquisitions.[297] In 1976, the section was amended to delete the provision which would deny a deduction for interest on corporate acquisition indebtedness where a corporation which had acquired at least 50 percent of the total combined voting power of all classes of stock of another corporation by October 9, 1969, incurred acquisition indebtedness in increasing its control over the acquired corporation to 80 percent or more.[298]

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[292] Subordinated to the claims of trade creditors generally, or expressly subordinated in right of payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued (sec. 279(b)(2)(A) and (B)).

[293] Convertible directly or indirectly into the stock of the issuing corporation or part of an investment unit or other arrangement which includes an option to acquire, directly or indirectly, stock in the issuing corporation (sec. 279(b)(3)(A) and (B)).

[294] Sec. 279(b)(4)(A).

[295] Sec. 279(b)(4)(B).

[296] Pub. L. No. 91-172.

[297] S. Rep. No. 91-552 (November 21, 1969). See also, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 123.

[298] Pub. L. No. 94-514.

6. Rules to address tax arbitrage in the case of borrowing to fund untaxed income

When debt is used to finance an investment that produces income exempt from tax, taxed at preferential rates, or carrying associated tax credits, the deduction for interest on the debt financing can be used to offset other, unrelated income. In addition, certain leveraged transactions by entities exempt from tax may present the opportunity for taxpayers to engage in transactions on terms they might not have in the absence of the tax-exemption. These outcomes are commonly referred to as "tax arbitrage." Following is a brief discussion of certain rules that attempt to limit the ability of taxpayers to engage in these types of transactions.

Interest Related to Tax-Exempt Income

Present law

Section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax ("tax-exempt obligations"). This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.[299] Generally, there are two methods for determining the amount of the disallowance. One method asks whether a taxpayer's borrowing can be traced to its holding of exempt obligations. A second method disallows interest deductions based on the pro rata percentage of a taxpayer's assets comprised of tax-exempt obligations.

The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations, so that the interest is available to offset other taxable income of the taxpayer

Tracing rules

Debt is traced to tax-exempt obligations if the proceeds of the indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations. For example, this rule applies if tax-exempt obligations are used as collateral for indebtedness. In general terms, the tracing rule applies only if the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Within the general framework of section 265, there are special rules for individuals, dealers in tax-exempt obligations, corporations that are not dealers, and certain financial institutions.

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[299] Section 7701(f) provides that the Secretary of the Treasury will prescribe regulations necessary or appropriate to prevent the avoidance of any income tax rules that deal with the use of related persons, pass-through entities, or other intermediaries in (1) the linking of borrowing to investment or (2) diminishing risks. See *H Enterprises International, Inc. v. Commissioner,* T.C.M. 1998-97, *aff'd.* 183 F.3d 907 (8th Cir. 1999) (Code section 265(a)(2) applied where a subsidiary borrowed funds on behalf of a parent and the parent used the funds to buy, among other investments, tax-exempt securities).

Dealers in tax-exempt obligations

In the case of a dealer in tax-exempt obligations (whether a corporation, partnership or sole proprietorship), if the proceeds are directly traceable to the purchase of tax-exempt obligations, no interest on the indebtedness is deductible.[300] If the use of the proceeds cannot be directly traced, an allocable portion of the interest deduction is disallowed. The amount of interest disallowed is determined by the ratio of (1) the dealer's average amount of tax-exempt obligations held during the taxable year to (2) the average amount of the dealer's total assets less the amount of any indebtedness the interest on which is not subject to disallowance to any extent under the provision.[301]

Corporations that are not dealers in tax-exempt obligations

In the case of a business that is not a dealer in tax-exempt obligations, if there is direct evidence of the purpose to purchase or carry tax-exempt obligations with the proceeds of indebtedness, then no interest on the indebtedness is deductible. In the absence of such direct evidence, the IRS provides specific inference rules. Generally, the purpose to purchase or carry tax-exempt obligations will not be inferred with respect to indebtedness incurred to provide funds for an active trade or business unless the borrowing is in excess of business needs.[302] In contrast, the purpose to carry tax-exempt obligations will be inferred (unless rebutted by other evidence) where a taxpayer could reasonably have foreseen at the time of purchasing tax-exempt obligations that indebtedness would have been incurred to meet future economic needs of an ordinary, recurrent variety.[303]

De minimis exception

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, taxpayers other than dealers may benefit from a de minimis exception.[304] The IRS takes the position that it will ordinarily not infer a purpose to purchase or carry tax-exempt obligations if a taxpayer's investment therein is "insubstantial."[305] A corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held in the active conduct of the corporation's trade or business.

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[300] Rev. Proc. 72-18, sec. 5.02.

[301] *Ibid.*, secs. 5.02 and 7.02.

[302] Rev. Proc. 72-18, sec. 6.01.

[303] Rev. Proc. 72-18, sec. 6.02.

[304] Rev. Proc. 72-18, sec. 3.05 provides that the insubstantial holding safe harbor is not available to dealers in tax-exempt obligations.

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

If a corporation holds tax-exempt obligations (installment obligations, for example) acquired in the ordinary course of its business in payment for services performed for, or goods supplied to, State or local governments, and if those obligations are nonsalable, the interest deduction disallowance rule generally does not apply.[306] The theory underlying this rule is that a corporation holding tax-exempt obligations in these circumstances has not incurred or carried indebtedness for the purpose of acquiring those obligations.

Financial institutions

After taking into account any interest disallowance rules under general rules applicable to other taxpayers,[307] Section 265(b)(2) disallows a portion of a financial institution's otherwise allowable interest expense that is allocable to tax-exempt interest. The amount of interest that is disallowed is an amount of interest expense that equals the ratio of the financial institution's average adjusted bases of tax-exempt obligations acquired after August 7, 1986 to the average adjusted bases of all the taxpayer's assets (the "pro rata rule").[308] This allocation rule is mandatory and cannot be rebutted by the taxpayer. A financial institution, for this purpose, is any person who accepts deposits from the public in the ordinary course of such person's trade or business, and is subject to Federal or State supervision as a financial institution or is a bank as defined in section 585(a)(2).

Exception for certain obligations of qualified small issuers

The general rule in section 265(b) denying financial institutions' interest expense deductions allocable to tax-exempt obligations does not apply to "qualified tax-exempt obligations." Instead, only 20 percent of the interest expense allocable to such qualified tax-exempt obligations is disallowed.[309] A qualified tax-exempt obligation is a tax-exempt obligation that is (1) issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond, and (3) is designated by the issuer as qualifying for the exception. A qualified small issuer is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less. The Code specifies circumstances under which an issuer and all subordinate entities are aggregated.[310] The special

[306] Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

[307] Including section 265(a) (see, sec. 265(b)(6)(A) and Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), p. 563), but section 265(b)(6)(B) specifies that the disallowance rule of section 265 is applied before the capitalization rule of section 263A (relating to the capitalization of certain expenditures).

[308] Sec. 265(b).

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

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

rule for qualified small issuers also applies to certain aggregated issuances of tax-exempt obligations in which more than one governmental entity receives benefits.[311]

Composite issues (*i.e.*, combined issues of bonds for different entities) qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).[312] Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

Special rules for obligations issued in 2009 and 2010

The American Recovery and Reinvestment Act of 2009 ("ARRA") modified certain provisions of section 265. Tax-exempt obligations issued during 2009 or 2010 and held by a financial institution, in an amount not to exceed two percent of the adjusted basis of the financial institution's assets, are not taken into account for the purpose of determining the portion of the financial institution's interest expense subject to the pro rata interest disallowance rule of section 265(b).

In connection with this change, ARRA also amended section 291(e) to provide that tax-exempt obligations issued during 2009 and 2010, and not taken into account for purposes of the calculation of a financial institution's interest expense subject to the pro rata interest disallowance rule, are treated as having been acquired on August 7, 1986. As a result, such obligations are financial institution preference items, and the amount allowable as a deduction by a financial institution with respect to interest incurred to carry such obligations is reduced by 20 percent.

With respect to tax-exempt obligations issued during 2009 and 2010, ARRA relaxed several rules related to qualified small issuers.

Legislative background

A provision denying a deduction for interest incurred in connection with tax-exempt obligations has been a part of the U.S. tax system since the Revenue Act of 1917, which allowed a deduction for "all interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation under this title."[313] Prior to 1986, banks were largely exempted from section 265

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[311] Sec. 265(b)(3)(C)(iii).

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

[313] Section 1201(1) of the Revenue Act of 1917. For a history of section 265, see George Craven, "Disallowance of Interest Deduction to Owner of Tax-Exempt Bonds," 24 *Tax Lawyer* 287 (1971).

pursuant to IRS rulings providing, inter alia, that interest paid to depositors was not interest incurred or continued to carry tax-exempt obligations[314] and that section 265 would generally not apply to interest on indebtedness incurred by banks in the ordinary course of business absent a direct connection between the borrowing and the tax-exempt investment.[315]

As part of the Tax Reform Act of 1986,[316] Congress amended section 265 to deny financial institutions an interest deduction in direct proportion to their tax-exempt holdings. Congress believed that allowing financial institutions to deduct interest payments regardless of tax-exempt holdings discriminated in favor of financial institutions at the expense of other taxpayers, and Congress was concerned that financial institutions could drastically reduce their tax liability using such rules. Congress believed that a proportional disallowance rule was appropriate because of the difficulty of tracing funds within a financial institution and the near impossibility of assessing a financial institution's purpose in accepting particular deposits.[317]

Debt with Respect to Certain Insurance Products

Present law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[318] ("inside buildup").[319] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[320]

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[314] Rev. Rul. 61-222, 1961-2 C.B. 58.

[315] Rev. Proc. 70-20.

[316] Pub. L. No. 99-514.

[317] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 562-3.

[318] By contrast to the treatment of life insurance contracts, if a deferred annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[319] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract for purposes of determining income taxes, other than those imposed on insurance companies such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (*i.e.*, income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, *i.e.*, generally is funded more rapidly than a policy that would provide paid-up future benefits after the payment of seven annual level premiums (sec. 7702A).

[320] Sec. 101(a).

Present law imposes limitations on the deductibility of interest on debt with respect to life insurance contracts. These limitations address the potential for arbitrage that could arise in the event that deductible interest expense relates to amounts excludable as inside buildup and as death benefits under a life insurance contract.

Interest paid or accrued with respect to the contract

No deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity, or endowment contract (the "single premium" deduction limitation).[321] A contract is treated as a single premium contract if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased or if an amount for payment of a substantial number of future premiums is deposited with the insurer.[322]

In addition, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity, or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[323] Several exceptions are provided for this rule. The deduction denial does not apply if (1) no part of four of the annual premiums due during the initial seven year period is paid by means of such debt; (2) if the total amounts to which the provision would apply in a taxable year does not exceed $100; (3) if the amounts are paid or accrued because of financial hardship; or (4) if the indebtedness is incurred in connection with the taxpayer's trade or business.[324]

Finally, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity, or endowment contract covering the life of any individual,[325] with a key person insurance exception.[326]

Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. This rule applies to interest for which a deduction is not disallowed under the other interest deduction disallowance rules

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[321] Sec. 264(a)(2).

[322] Sec. 264(c).

[323] Sec. 264(a)(3).

[324] Sec. 264(d).

[325] Sec. 264(a)(4).

[326] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise nondeductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. Other special rules apply.

relating to life insurance including, for example, interest on third-party debt that is not with respect to a life insurance, annuity, or endowment contract. Under this rule, in the case of a taxpayer other than a natural person,[327] no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[328] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business.[329] The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

An employer may exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.

Legislative background

A limitation has applied to the deductibility of interest with respect to single premium life insurance contracts since 1942.[330] Additional interest deduction limitations with respect to life insurance, annuity, and endowment contracts were added in 1964 and 1986.[331] More recently, further interest deduction limitations with respect to such insurance contracts were added in 1996 and again in 1997.[332] In general, these interest deduction limitations have been based in part on

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[327] See sec. 264(f)(5).

[328] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

[329] Sec. 264(f)(4).

[330] Current sec. 264(a)(2) (former sec. 24(a)(6) of the 1939 Code), enacted in the Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, sec. 129, 77th Cong., 2d Sess., October 21, 1942.

[331] Sec. 264(a)(3), enacted in the Revenue Act of 1964, Pub. L. No. 88-272, sec. 215, 88th Cong., 2d Sess., 1964; sec. 264(a)(4) and (e)(1) (subsequently modified), enacted in the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 99th Cong., 2d Sess., October 22, 1986. In addition to interest deduction limitations, limitations are imposed on the deductibility of premiums with respect to life insurance, annuity, and endowment contracts (sec. 264(a)(1)).

[332] Current sec. 264(e), enacted in the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 501, 104th Cong., 2d. Sess., July 31, 1996; and sec. 264(f), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 105th Cong., 1st Sess., July 30, 1997.

concern over the opportunity for tax arbitrage, that is, the deductibility of interest expense with respect to untaxed investment income (inside buildup) of the insurance contract.[333]

For example, in enacting the interest deduction limitations in 1997, Congress expressed concern about the tax arbitrage of deducting interest expense that funds untaxed income:

In addition, the Committee understands that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts. The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the bill provides that for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.[334]

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts[335] (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation).[336]

Debt-Financed Income of Tax-Exempt Organizations

Present law

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,[337] such organizations may be subject to the unrelated business income tax ("UBIT")[338] on income derived from property financed with debt.[339]

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[333] For example, in enacting the 1964 interest deduction limitation, Congress stated, "The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured." Revenue Act of 1963, Report of the Committee on Ways and Means, H.R. Rep. No. 749, 88th Cong., 1st Sess., page 61, September 13, 1963. As a further example, following enactment of the 1986 interest deduction limitation, the reasons for change included this statement: "This provision provides a cap on the deductibility of such interest, rather than phasing out deductibility. The provision was structured in this manner to allow small businesses to use loans on life insurance policies for their employees as a source of short-term capital when necessary. Congress did not intend to allow these loans to be an unlimited tax shelter as under prior law." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, p. 579, May 4, 1987.

[334] Revenue Reconciliation Act of 1997 (as Reported by the Senate Committee on Finance), S. Rep. No. 105-33, 105th Cong., 1st Sess., p. 187, June 20, 1997 (footnotes omitted).

[335] Sec. 101(j).

[336] Pension Protection Act of 2006, Pub. L. No. 109-280.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business taxable income in proportion to the amount of acquisition indebtedness on the income-producing property.[340] Certain educational organizations, pension funds, title holding companies, and retirement income accounts are eligible for an exception to the debt-financed income rules for investments in real property.[341]

Legislative background

Until the introduction of the UBIT in 1950, there was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. In response to certain abusive transactions,[342] Congress subjected charitable organizations (not including churches) and certain other exempt organizations to tax on their unrelated business income as part of the Revenue Act of 1950.[343]

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[337] Sec. 501(a).

[338] Secs. 511-514. In general, UBIT taxes income derived from a regularly carried on trade or business that is not substantially related to the organization's exempt purposes. Certain categories of income—such as interest, dividends, royalties, and rent—are generally exempt from UBIT. For example, tax-exempt organizations are not taxed on interest income they receive from investments in debt or other obligations.

[339] Tax-exempt organizations subject to UBIT include those described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2). Organizations liable for UBIT may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

[340] Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization in acquiring or improving the property and indebtedness incurred either before or after acquisition or improvement that would not have been incurred but for the acquisition or improvement of the property. Sec. 514(c)(1).

[341] Sec. 514(c)(9)(A). Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. In addition to the real property exception, acquisition indebtedness does not include (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, and (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low- and moderate-income persons. See secs. 514(c)(4), (5), and (6), respectively.

[342] For example, in one type of transaction, a tax-exempt organization borrows the entire purchase price of real property, purchases the property and leases it back to the seller under a long-term lease, and services the loan with tax-free rental income from the lease. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[343] Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the UBIT to the income of State colleges and universities. Sec. 511(a)(2)(B).

The 1950 Act taxed as unrelated business income certain rents received in connection with the leveraged sale and leaseback of real estate.[344] This provision was a precursor to the present-law tax on unrelated debt-financed income.

In the Tax Reform Act of 1969, Congress extended UBIT to all tax-exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities).[345] In addition, the 1969 Act expanded the tax on debt-financed income beyond rents from debt-financed acquisitions of real property to encompass debt-financed income from interest, dividends, other rents, royalties, and certain gains and losses from any type of property.[346]

In the Miscellaneous Revenue Act of 1980, Congress enacted an exception to the debt-financed income rules for certain real property investments by qualified pension trusts (the progenitor of the real property exception).[347]

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations and layered on additional conditions, including an absolute bar on seller financing and an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property.[348] In 1987, Congress further modified the restrictions on partnerships of qualified organizations investing in debt-financed real property by enacting the fractions rule.[349] In 1993, Congress relaxed some of the conditions required to meet the real property exception.[350]

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[344] There was an exception for rental income from a lease of five years or less. For a discussion of Congress's objections to such transactions, see H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[345] Pub. L. No. 91-172. The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

[346] For a discussion of the reason for the expanding the debt-financed income rules in 1969, see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

[347] Pub. L. No. 96-605. Congress believed that such an exception was warranted because "the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose—the payment of employee benefits." S. Rep. No. 96-1036, 96th Cong., 2d Sess. 29 (1980). In addition, the exemption provided to pension trusts was appropriate because, unlike other exempt organizations, the assets of such trusts eventually would be "used to pay taxable benefits to individual recipients whereas the investment assets of other [exempt] organizations . . . are not likely to be used for the purpose of providing benefits taxable at individual rates." *Ibid*. In other words, the exemption for qualified trusts generally results only in deferral of tax; unlike the exemption for other organizations.

[348] Pub. L. No. 38-369. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1151.

[349] Sec. 514(c)(9)(B)(vi) & (E), enacted in section 10214 of The Revenue Act of 1987, Pub. L. No. 100-203. The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners. See H.R. Rep. No. 100-391, H.R. 3545, Report to accompany recommendations from the Committee on Ways and Means, House of Representatives, October 26, 1987, p. 1076. Under the fractions rule, the allocation of

Dividends Received Deduction Reduction for Debt-Financed Portfolio Stock

Present law

In general, a corporate shareholder is allowed a deduction equal to (1) 100 percent of certain qualifying dividends received from a corporation in the same affiliated group as the recipient;[351] (2) 80 percent of the dividends received from a corporation if it owns at least 20 percent of the payee's stock (by vote and value); and (3) 70 percent of dividends received from other corporations.[352] The purpose of the dividends received deduction is to reduce multiple corporate-level taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder.

However, if dividends are paid on debt-financed stock, the combination of the dividends received deduction and the interest deduction would enable corporate taxpayers to shelter unrelated income. Therefore, section 246A generally reduces the 80 percent and 70 percent dividends received deduction so that the deduction is available, in effect, only with respect to dividends attributable to that portion of the stock which is not debt-financed.[353] Under regulations prescribed by the Secretary, any reduction in the amount allowable as a dividends received deduction under the rule is limited to the amount of the interest allocable to the dividend.[354]

Section 246A applies to dividends on debt-financed "portfolio stock" of the recipient corporation. Stock of a corporation is portfolio stock unless specifically excluded. Stock is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and (2) having a value equal to at least 50 percent of the value of

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items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of overall partnership loss for the taxable year for which such partner's loss share will be the smallest. Sec. 514(c)(9)(E)(i)(I). A partnership generally must satisfy the fractions rule both currently and for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization. Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

[350] See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

[351] Sec. 243(a)(3) and (b). An affiliated group generally consists of a common parent corporation and one or more other corporations at least 80 percent of the stock of which (by vote and value) is owned by the common parent or another member of the group.

[352] Sec. 243. Section 245 allows a 70 percent, 80 percent and 100 percent deduction for a specified portion of dividends received from certain foreign corporations. Section 244 allows a dividends received deduction on certain preferred stock of public utilities.

[353] The reduction of the dividends received deduction may be viewed as a surrogate for limiting the interest deduction.

[354] Sec. 246A(e). Treasury has not issued regulations under section 246A.

all the stock, of such corporation.[355] Portfolio stock is debt-financed if there is a direct relationship between indebtedness and the portfolio stock. The provision does not incorporate any allocation or apportionment formula or fungibility concept.

Legislative background

Section 246A was enacted by the Deficit Reduction Act of 1984,[356] in response to concern that corporate taxpayers were borrowing money (giving rise to deductible interest payments) to purchase portfolio stock that paid dividends (partially excluded from income by the dividends received deduction), thus allowing such taxpayers to use the deduction for dividends paid or accrued to shelter unrelated income. Congress did not believe these two deductions were intended to provide such shelter.[357]

7. Rules to match timing of tax deduction and income inclusion relating to debt

Statutory limitations on the deductibility of interest expense apply in some cases in which an immediate deduction would produce a mismatching of income and expense. If the full interest deduction is not permitted on a current basis, the deduction may be disallowed, deferred until a later time, or required to be capitalized into the basis of related property. Following is a brief description of some rules designed to match the timing of income and deductions related to debt.

Interest and OID on Amounts Payable to Related Foreign Lenders

Accrued but unpaid interest

Special rules apply to a debt instrument issuer's deduction for accrued but unpaid interest, and accrued OID, owed to certain related persons. These rules are generally designed to match the issuer's deduction with the holder's corresponding income inclusion.

A number of rules limit deductions for losses, expenses, and interest with respect to transactions between related persons. In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid, but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[358] This rule is intended to prevent the mismatch of, for example,

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[355] The 50 percent threshold is reduced to 20 percent if five or fewer corporate stockholders own, directly or indirectly, stock possessing at least 50 percent of the voting power and value of all the stock of such corporation. This rule was intended to exempt certain corporate joint ventures from the provision. See, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

[356] Pub. L. No. 98-369.

[357] See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 128.

[358] Sec. 267(a)(2).

a deduction for interest accrued by a taxpayer on the accrual method of accounting that is payable to a related person on a cash method of accounting. In the absence of this rule, the issuer would take a deduction upon accrual of the obligation to pay interest (whether or not the interest was actually paid), but a related holder would not take the interest into income until it is paid.

U.S.-source "fixed or determinable annual or periodical" income, including dividends, interest, rents, royalties, and other similar income, is subject to a 30-percent gross-basis withholding tax when paid to a foreign person.[359] This withholding tax can create a mismatch where, for example, a U.S. accrual-method taxpayer borrows amounts from a foreign corporation. In the absence of a special rule, the U.S. taxpayer would be allowed a deduction for accrued interest annually even if no interest were actually paid, and the foreign corporate lender would be subject to the 30-percent gross-basis withholding tax only when the interest was paid. The Code directs the Treasury Secretary to issue regulations applying the matching principle in this circumstance and other circumstances involving payments to related foreign persons.[360] With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations require a taxpayer to use the cash method of accounting in deducting amounts owed to related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[361]

A foreign corporation's foreign-source active business income generally is subject to U.S. tax only when such income is distributed to any U.S. person owning stock of such corporation. Accordingly, a U.S. person conducting foreign operations through a foreign corporation generally is subject to U.S. tax on the foreign corporation's income only when the income is repatriated to the United States through a dividend distribution. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which a U.S. person holds stock. The main anti-deferral rules are the controlled foreign corporation ("CFC") rules of subpart F[362] and the passive foreign investment company ("PFIC") rules.[363] Section 267(a)(3)(B) provides special rules for items payable to a CFC or a PFIC. In general, with respect to any item payable to a related CFC or a PFIC, deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the

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[359] Secs. 871, 881, 1441, 1442.

[360] Section 267(a)(3)(A).

[361] Treas. Reg. sec. 1.267(a)-3(b)(1), -3(c).

[362] Secs. 951 – 964.

[363] Secs. 1291 – 1298.

relevant inclusion rules. Deductions that have accrued but are not allowable under this special rule are allowed when the amounts are actually paid.

Original issue discount

Rules similar to those discussed above apply in the case of OID on debt instruments held by a related foreign person. In such case, section 163(e)(3)(A) disallows a deduction for any portion of such OID until paid by the issuer (the "related-foreign-person rule").[364] This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the foreign related person's conduct of a U.S. trade or business (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[365]

In the case of any OID debt instrument held by a related foreign person which is a CFC or a PFIC, deductions for accrued but unpaid OID are similarly allowable only to the extent that such OID is, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation.[366]

Legislative background

Section 163(e)(3) was enacted by the Deficit Reduction Act of 1984[367] to address the mismatch that occurred if a current deduction was allowed for the accrual of interest on an OID instrument before the interest was actually paid. The Conference Report notes that "there is no justification for mismatching in the case of related-party OID debt. Such mismatching allows an economic entity that has divided itself into more than one legal entity to contract with itself at the expense of the U.S. Government."[368]

The section 267(a)(3) rule directing the Secretary of the Treasury to issue regulations extending the matching principle to payments made to a non-U.S. person was enacted in the Tax Reform Act of 1986.

In 2004, as part of AJCA, Congress added the special rules for CFCs and PFICs because prior law (which assumed there would be little material distortion in the matching of income and deductions in the context of the these anti-deferral regimes) failed to take into account the situation in which amounts are included in the income of a related foreign corporation but are not currently included in the income of the foreign corporation's U.S. shareholder(s).

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[364] Sec. 163(e)(3)(A).

[365] Sec. 163(e)(3)(A).

[366] Sec. 163(e)(3)(B).

[367] Pub. L. No. 98-369.

[368] H.R. Conf. Rep. 98-861.

Construction Period Interest

Present law

Section 263A generally denies a current deduction for costs incurred in manufacturing or constructing tangible property, requiring that such costs be capitalized. In particular, section 263A(f) provides that interest paid or incurred during the production period of certain types of property, and that is allocable to the production of the property, must be capitalized into the adjusted basis of such property. Interest is allocable to the production of property for these purposes if it is interest on debt that can be specifically traced to production expenditures. If production expenditures exceed the amount of the specifically traceable debt, then other interest expense that the taxpayer would have avoided if amounts incurred for production expenditures instead had been used to repay the debt also is treated as allocable to the production of property (the "avoided cost" method of allocating interest). Section 263A(f) requires the capitalization of interest on debt that is allocable to property which has a long useful life,[369] an estimated production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million.[370]

By requiring that certain interest expense be capitalized, section 263A effectively defers the deduction for interest paid until the related income is recognized.

Legislative background

Section 263A was enacted by the Tax Reform Act of 1986.[371] Congress believed that a comprehensive set of rules governing the capitalization of costs of producing, acquiring, and holding property, including interest expense, was advisable to reflect income more accurately, and to alleviate distortions in the allocation of economic resources and the manner in which certain activities are organized.[372] The Technical and Miscellaneous Revenue Act of 1988[373] clarified the application of the interest allocation rule.

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[369] Property has a long useful life for this purpose if such property is real property or is property with a class life of 20 years or more (as determined under section 168) (sec. 263A(f)(4)(A)).

[370] Sec. 263A(f)(1)(B).

[371] Pub. L. No. 99-514.

[372] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 508-509.

[373] Pub. L. No. 100-647.

Interest in the Case of Straddles

Present law

A straddle generally refers to offsetting positions with respect to actively traded personal property.[374] Positions are offsetting if there is a substantial diminution in the risk of loss from holding one or more other positions in personal property.[375]

Section 263(g) requires taxpayers to capitalize certain otherwise deductible expenditures allocable to personal property that is part of a straddle. Thus, these expenditures effectively reduce the gain or increase the loss recognized upon disposition of the property. Expenditures subject to this requirement are interest on indebtedness incurred or continued to carry property (including any amount paid or incurred in connection with personal property used in a short sale) as well as other amounts paid or incurred to carry the property, including insurance, storage or transportation charges ("carrying charges"). The amount of expenditures to be capitalized is reduced by certain income amounts with respect to the personal property.[376]

Legislative background

The limitation on deductibility of straddle interest and carrying charges (along with the straddle rules more generally[377]) was enacted in 1981[378] in response to the use of certain straddles, which were executed with deductible financing and carrying charges, to defer ordinary income and to convert it into long-term capital gain (referred to as "cash and carry" shelters). Such shelters typically involved the debt-financed purchase of a physical commodity, for example silver, and an offsetting futures contract to deliver the silver in a subsequent taxable year. The taxpayer would deduct interest expense, storage and insurance costs in the first year, offsetting ordinary investment income. After 12 months, if the price of silver declined, the taxpayer could deliver the silver to satisfy the futures contract, realizing a gain on the silver. If the price of silver had increased, the taxpayer could sell the silver, producing long-term capital gain, and close out the short futures position, creating a short-term capital loss. In either event, the net gain on the two positions would approximately equal the carrying charges, but would be reported as capital gain. By requiring the capitalization of financing and carrying charges Congress sought to discourage these transactions.[379]

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[374] Secs. 1092(c)(1) and 1092(d)(1).

[375] Sec. 1092(c)(2).

[376] Sec. 263(g)(2)(B)(i) - (iv).

[377] Sec. 1092. The straddle rules generally defer a loss on a position that is part of a straddle to the extent the amount of the loss does not exceed the amount unrecognized gain on offsetting positions in the straddle.

[378] Economic Recovery Tax Act of 1981, Pub. L. No. 97-37.

[379] See Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, pp. 292-293.

In 1984, the straddle rules were expanded to include exchange traded stock options in response to transactions exploiting the exemption of stock and exchange-traded stock options from the straddle rules.[380] For example, such transactions used offsetting deep-in-the-money options on stock, the value of which could be expected to move in roughly opposite directions.[381]

In 1986, section 263(g)(2) was amended to include in the definition of interest and carrying charges any amount which is a payment with respect to a securities loan.[382]

In 2004 the straddle rules were broadened to include actively traded stock. The same legislation provided, among other things, that at the time a taxpayer acquires a straddle the taxpayer is permitted to identify the straddle as an 'identified straddle' and thereby subject the positions composing the straddle to a basis adjustment rule rather than to the general loss deferral rule of section 1092(a)(1).

8. Other rules relating to business debt and equity

Employee Stock Ownership Plans

In general

An employee stock ownership plan ("ESOP") generally is a type of qualified retirement plan that is designed to invest primarily in securities of the employer maintaining the plan.[383] An ESOP can be maintained by either a C corporation or an S corporation. An employer corporation may lend money to an ESOP, or the employer corporation may guarantee a loan made by a third-party lender to the ESOP, to finance the ESOPs purchase of employer securities. An ESOP that borrows funds to acquire employer securities generally is called a leveraged ESOP. In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP acquisition loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (25 percent of the participants' compensation in

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[380] Deficit Reduction Act of 1984, Pub. L. No. 98-369. See also, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

[381] See, e.g., Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 306-308.

[382] Tax Reform Act of 1986, Pub. L. No. 99-514.

[383] Under section 4975(e)(7), in order to be an ESOP (as opposed to another type of qualified retirement plan), the plan must satisfy certain other requirements. The employer securities must be qualified employer securities as defined in section 409(l) (which generally requires use of readily tradable securities, if available, or common stock with the greatest voting power and dividend rights). The plan must satisfy the distribution and put option requirements of section 409(h) and (o) (which generally require distributions be available in employer stock for other than S corporation stock, and distributions of stock that is not readily tradable to be able to put to the employer), the voting rights requirements of section 409(e) (which require that voting rights on shares held by the ESOP be passed through to ESOP plan participants in certain circumstances), and the nonallocation requirements of section 409(n) (which apply if the seller of stock to an ESOP claims nonrecognition treatment) and 409(p) (which apply in the case of ESOP maintained by an S corporation). The plan also must satisfy other requirements provided in Treasury regulations.

the case of a defined contribution plan) but the limit is applied separately to the payments of principal for the year, and interest payments are deductible without regard to the limitation.[384] In addition, dividends paid with respect the employer stock of a C corporation held by an ESOP that are passed through to participants or used to make acquisition loan payments generally may also be deductible.[385] This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans. There is also a nonrecognition provision for sales of C corporation employer stock to an ESOP by a shareholder.[386]

Because an ESOP is a qualified retirement plan, the assets of an ESOP, including the employer securities purchased with the loan are held in a tax-exempt trust. For an S corporation maintaining an ESOP, the trust of the ESOP is also exempt from UBIT.[387] There are restrictions that limit the grant of stock options by an S corporation that maintains an ESOP but it is possible in certain circumstances to grant options or warrants for S corporation stock that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the stock.[388]

Because an ESOP is a qualified retirement plan, it must satisfy the rules applicable to qualified plans generally (that are designed to protect the interest of participants and limit the amount of deferred compensation that is permitted in the plan) as well as a number of rules that only apply to leveraged ESOPs (to protect the plan against fiduciary self-dealing and to ensure that employees actually enjoy the benefits of stock ownership).

Prohibited transaction exemption for ESOPs

Prohibited transaction rules

In order to prevent persons with a close relationship to a qualified retirement plan from using that relationship to the detriment of plan participants and beneficiaries, the Code and ERISA prohibit certain transactions between a qualified retirement plan and a disqualified person.[389] A disqualified person includes any fiduciary, a person providing services to the plan,

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[384] Sec. 404(a)(9).

[385] Sec. 404(k). If the dividend is paid with respect to stock allocated to a participant's accounts, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant.

[386] Sec. 1042. Further detail on this provision is contained in Present Law related to Pensions/Retirement.

[387] Sec. 512(e)(3).

[388] See the nonallocation rules under section 409(p) for the limits on stock options and other synthetic equity, provided by an S corporation that maintains an ESOP, and section 4976A for the excise tax consequences. Further detail on this provision is contained in Present Law related to Pensions/Retirement.

[389] Section 4975 of the Code and section 406 of ERISA. The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction.

an employer any of whose employees are covered by the plan, an employee organization of which any members are covered by the plan, and certain persons related to such disqualified persons. Transactions prohibited between the plan and a disqualified person include among others (1) the sale or exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, service, or facilities.

Exemptions for leveraged ESOPs

Two statutory exemptions to the prohibited transaction rules permit the existence of leveraged ESOPS. First, qualified plans are allowed to acquire qualifying employer securities for "adequate consideration."[390] Second, an ESOP (but not any other qualified retirement plan) is permitted to borrow from the employer or other disqualified person, or the employer is permitted to guarantee a loan to an ESOP by a third party lender, to acquire employer securities.[391]

To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan. The loan must be for a specific term and the interest rate for the loan must not be in excess of a reasonable rate.[392] Any collateral given to a disqualified person by the plan in connection with the loan must consist only of qualifying employer securities and generally only those acquired with the proceeds of the loan.[393] The shares are held in a suspense account under the plan but must be released and allocated to participants as the loan is repaid under one of two specific methods provided in the regulations.[394] In the event of default on the loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default.[395]

In the case of a distribution of cash by an S corporation (as described in section 1368(a)) to a leveraged ESOP with respect to its stock, the ESOP is permitted to use distributions with respect to unallocated shares held in the suspense account to make payments (principal and interest) on the acquisition loan.[396] Such use of the distribution is not a prohibited transaction and will not cause the plan to violate the qualification requirements.

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[390] Sec. 408(e) of ERISA and section 4975(e)(13) of the Code..

[391] Sec. 408(b)(3) of ERISA and sec. 4975(d)(3) of the Code.

[392] Treas. Reg. sec. 54.4975-7(b)(7).

[393] Treas. Reg. sec. 54.4975-7(b)(5).

[394] Treas. Reg. sec. 54.4975-7(b)(8).

[395] Treas. Reg. sec. 54.4975-7(b)(6).

[396] Sec. 4975(f)(7). If the distribution is paid with respect to allocated stock purchased with the loan being repaid and is used to repay the acquisition loan, the plan must allocate employer securities with a fair market value of not less than the amount of such distribution to the participant for the year in which such distribution would have been allocated to such participant.

Legislative background

The term "employee stock ownership plan" was added to the Code by the Employee Retirement Income Security Act of 1974 ("ERISA"). However, prior to ERISA, stock bonus plans could be structured to be the equivalent of a leveraged ESOP.[397]

The Tax Reform Act of 1984[398] and Tax Reform Act of 1986[399] added most of the present law special deduction and nonrecognition of gain provisions with respect to leveraged ESOPs.

S corporations

Prior to 1998, trusts of retirement plan qualified under section 401(a) were not permitted as shareholders of S corporations. Thus, prior to 1998, ESOPs could be maintained only by C corporations. The Small Business Job Protection Act of 1996 ("SBJPA") amended section 1361 to allow trusts qualified under section 401(a) to be S corporation shareholders. This change was specifically intended to allow S corporations to maintain ESOPs. Under SBJPA, the pass-through income from an S corporation to an ESOP as an S corporation shareholder was subject to UBIT. The Taxpayer Relief Act of 1997 amended section 512(e) to provide an exemption from UBIT for the pass-through income from an S corporation to an ESOP with respect to the S corporation shares held by the ESOP as qualified securities.[400] A qualified plan that is not an ESOP continues to be subject to UBIT on the pass-through income on any shares of S corporation stock held in the plan's trust. The legislative history to the Taxpayer Relief Act of 1997[401] gives as the reason for the ESOP exemption from UBIT that subjecting S corporation ESOP income to UBIT is not appropriate because "such amounts would be subject to tax at the ESOP level and also again when benefits are distributed to ESOP participants." [402]

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[397] Specifically a stock bonus plan, a type of retirement plan qualified under section 401(a), could be structured as a plan invested primarily in employer securities acquired using funds borrowed by the plan.

[398] Pub. L. No. 98-369.

[399] Pub. L. No. 99-514.

[400] The exemption from UBIT treatment for an ESOP holding stock of an S corporation allowed an S corporation with one employee (or a very small number of employees) to establish an ESOP and transfer all their shares of S Corporation stock to the ESOP (possibly through a leveraged transaction that allowed the stock to be held in a suspense account until they could be allocated to the participant's accounts). This allowed the creation of a tax-exempt S corporation with shares owned through the ESOP by a small number of individuals.

[401] Pub. L. No. 105-34, Senate Report 105-033.

[402] When the stock is redeemed or sold to provide distributions from the plan to plan participants, the pass-through income may ultimately be subject to tax as ordinary income. However, this may occur many years after the income was earned by the S corporation, a deferral that can significantly reduce the present value of the tax. Furthermore, if the stock declines in value such that the value of all the income allocations to the ESOP is not included in the amount distributed to plan participants, the S corporation income is never taxed to that extent.

The Economic Growth and Tax Reconciliation Act of 2001[403] added section 409(p) which placed some limitations on the concentration of stock ownership through the ESOP and the use of synthetic equity, as defined in section 409(p)(6)(C) (which generally includes any stock option, warrant, restricted stock, deferred issuance stock right or similar interest or right to acquire or receive stock in the S corporation in the future, and certain other rights).

Nonqualified Preferred Stock Not Treated as Stock for Certain Purposes

In general

Under section 351 of the Code, a transfer of property to a corporation in exchange solely for stock of the transferee corporation is generally tax-free to each transferor. Neither gain nor loss is recognized with respect to the transferred property, provided that immediately after the transfer the transferors, in the aggregate, are in control (as defined in section 368(c)) of the corporation.[404]

If, in addition to stock, the transferor receives other property ("boot"), such as money or securities of the transferee corporation, then the transferor recognizes gain (but not loss) on the transfer (to the extent of the value of the other property).

The transferor recognizes gain or loss on a transfer of property, however, if the transfer fails to meet the requirements of the nonrecognition rules, for example, by failing the applicable control requirement,[405] or not receiving any stock in the exchange.

Since 1997, the Code has required nonqualified preferred stock ("NQPS") to be treated as if it were not stock for some purposes but not others unless the Secretary of the Treasury so prescribes.[406] In particular, section 351(g) provides that NQPS is not stock for purposes of

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[403] Pub. L No. 107-16.

[404] Control for this purpose means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. The IRS has ruled that "control" requires ownership of 80 percent of each class of stock that is not entitled to vote (Rev. Rul. 59-259, 1959-2 C.B. 115). Taxpayers may be able to construct stock that has a higher percentage of the vote than of value (or vice versa) and retain (or fail to retain) the amount of each class necessary to satisfy (or to fail to satisfy) this test in various circumstances.

The definition of control for this purpose is different from the definition for certain other purposes – for example, for purposes of allowing a tax-free liquidation of a subsidiary corporation into a parent (sec. 332), or for purposes of the rules treating certain transfers of stock between commonly controlled corporations as a contribution of the stock followed by a redemption distribution that is generally treated as a dividend (sec. 304).

[405] Certain prearranged dispositions of stock that would cause a failure of the control requirement may cause a transaction not to be within the scope of section 351, so that loss or gain on the transferred property is recognized. See, *e.g.*, Rev. Rul. 54-96, 1954-1 C.B. 111 (prearranged plan caused loss of control); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (finding incorporator lacked requisite control under section 351 where, as part of the incorporation, he irrevocably contracted to sell 50 percent of the stock received).

[406] The Secretary of the Treasury has regulatory authority to prescribe the treatment of NQPS for any other purpose of the Code. The regulatory authority has never been exercised.

section 351, with the result that NQPS received in an otherwise valid section 351 transaction is taxable boot.[407]

Definition of nonqualified preferred stock

Preferred stock is defined as stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.[408] Preferred stock is generally "nonqualified preferred stock" if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock within the 20-year period beginning on the issue date of the stock, and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase; (2) the issuer or a related person is required to redeem or purchase the stock within such 20-year period and such right or obligation is not subject to a contingency which as of the issue date makes remote the likelihood of redemption or repurchase; (3) the issuer or a related person has the right to redeem or purchase the stock within such 20-year period and, as of the issue date, it is more likely than not that such right will be exercised; or (4) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[409]

A right or obligation will not cause preferred stock to be NQPS, however, if (1) the stock relinquished or received is not in a corporation any of whose stock is, or is to become, publicly traded, and the right or obligation may be exercised only upon the death, disability, or mental incompetency of the holder, or (2) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.[410]

Other consequences of nonqualified preferred stock

In addition to the rules dealing with transfers to a controlled corporation, other corporate tax rules also permit certain reorganizations, divisions, and recapitalizations of corporations to be accomplished without tax to the exchanging shareholders or the corporations involved, provided that certain requirements are met and only to the extent that certain permitted property is received. Under these rules, NQPS that is exchanged or received with respect to stock other than NQPS is generally not treated as permitted property (with an exception for certain recapitalizations of family-owned corporations) so that gain (but not loss) is generally recognized on certain exchanges of stock in one corporation for NQPS in another, where the basic

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[407] For a discussion of certain incentives to use nonqualified preferred stock, and consideration of other aspects of present law taxpayers may use to accomplish similar results, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 385-394.

[408] Sec. 351(g)(3)(A).

[409] Sec. 351(g)(2)(A) and (B).

[410] Sec. 351(g)(2)(C).

requirements of a qualifying transaction are otherwise met. However, except as provided in regulations, unlike the case of the section 351 transaction, the NQPS is treated as stock for purposes of determining whether a transaction qualifies as a tax-free reorganization or division (apart from the rules for determining the extent of taxable boot received in such a transaction).[411]

Legislative background

Section 351(g) was enacted by the Tax Relief Act of 1997.[412] The legislative history states that the Congressional concern leading to the adoption of the rules was that "certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments."[413]

In 2004, the statute was amended to add a statement that stock shall not be treated as so participating unless there is "a real and meaningful likelihood" of the shareholder actually participating in the earnings and growth of the corporation."[414] The change was made in response to Congressional concern that taxpayers might attempt to avoid the characterization of an instrument as NQPS by including illusory participation rights or including terms that taxpayers could argue create an "unlimited" dividend.[415] In 2005, the statute was amended again, to provide that "if there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends."[416]

9. Treatment of capital gains and losses under present law

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income.[417] Net capital gain is the excess of the net

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[411] Secs. 354(b)(2)(C), 355(a)(3)(D), and 356(e).

[412] Pub. L. No. 105-34.

[413] H.R. Rep. No. 105-148, June 24, 1997, p. 472; S. Rep. No. 105-33, June 20, 1997, p. 150. See, also, Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* (August 2010), ¶ 902.1 et seq., giving an example of a similar transaction that could have been impacted by the 1997 legislation. That example is based on the facts of the acquisition of National Starch & Chemical Corp. detailed in *National Starch & Chemical Corp. v. Commissioner*, 93 T.C. 67 (1978) *aff'd*, 918 F.2d 426 (3rd Cir. 1990) which refers to a private letter ruling dated June 28, 1978 (described by Ginsburg and Levin as PLR 7839060 (June 28, 1978)).

[414] Pub. L. No. 108-357, sec. 899(a), amending section 351(g)(3).

[415] S. Rep. No. 108-192.

[416] Pub. L. No. 109-135, sec. 403(kk), amending section 351(g)(3).

[417] Sec. 1(h).

long-term capital gain for the taxable year over the net short-term capital loss for the year.[418] Gain or loss is treated as long-term if the asset is held for more than one year.[419]

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct up to $3,000 of capital losses against ordinary income in each year.[420] Any remaining unused capital losses may be carried forward indefinitely to another taxable year.[421]

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.[422] In addition, the net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business is treated as long-term capital gain.[423]

Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances.[424] Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.[425]

Tax rates

Under present law, any adjusted net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate; any adjusted net capital gain that otherwise would be taxed at a 25-, 28-, 33-, or 35-percent rate is taxed at a 15-percent rate; and any adjusted net capital gain that otherwise would be taxed at a 39.6 percent rate is taxed at a 20-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax ("AMT").

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[418] Sec. 1222(11).

[419] Sec. 1222(3).

[420] The limitation on the deduction of capital losses in excess of capital gains was enacted by the Revenue Act of 1934. Pub. L. No. 73-216.

[421] Secs. 1211(b) and 1212(b).

[422] Sec. 1221.

[423] 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.

[424] Sec. 1245.

[425] Sec. 1250.

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

The term 28-percent rate gain means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles[426] and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

Unrecaptured section 1250 gain means any long-term capital gain from the sale or exchange of section 1250 property (*i.e.*, depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 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.

Table 7 below details the tax rates applicable to income from different investments yielding capital gains.

[426] The term collectible means any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property specified by the Secretary of the Treasury. Sec. 408(m)(2).

Table 7.−Tax Rates Applicable to Certain Categories of Income, 2013

		Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**35%**	**39.6%**	**26%**	**28%**
Qualified dividend income	0	0	15	15	15	15	20	same as regular tax	
Nonqualified dividend income and short-term capital gain[1]	10	15	25	28	33	35	39.6	26	28
Long-term capital gain[2]	0	0	15	15	15	15	20	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	28	26	28
Small business stock issued before February 18, 2009[4]	0	0	12.5	14	14	14	14	13.91	14.98
Empowerment zone small business stock issued before February 18, 2009	0	0	10	11.2	11.2	11.2	11.2	11.592	12.376
Small business stock issued after February 17, 2009, and before September 28, 2010	0	0	6.25	7	7	7	7	7.865	8.47
Small business stock issued after September 27, 2010 and before January 1, 2014; D.C. Enterprise Zone stock; Renewal Community stock[6]	0	0	0	0	0	0	0	0	0

Notes:

[1] Gain from assets held not more than one year.

[2] Gain from assets held more than one year not included in another category.

[3] Capital gain attributable to depreciation on section 1250 property (*i.e.*, depreciable real estate).

[4] Effective rates after application of 50-percent exclusion for small business stock held more than five years.

[5] Effective rates after application of 60-percent exclusion for small business empowerment zone stock held more than five years.

[6] D.C. Enterprise Zone stock issued after December 31, 1997, and before January 1, 2012, and Renewal Community stock issued after December 31, 2001, and before January 1, 2010. The stock must be held for more than five years.

Tax on net investment income

For taxable years beginning after December 31, 2012, 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 or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. For these purposes, net investment income includes capital gains.[427]

For purposes of this tax, modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.[428]

Certain nonrecognition events

Like-kind exchanges

In general. – An exchange of property, like a sale, generally is a taxable transaction. However, section 1031 provides that no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that is also held for productive use in a trade or business or for investment.[429] This provision does not apply to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, partnership interests, choses in action, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest,[430] or to certain exchanges involving livestock[431] or involving foreign property.[432]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other property or money, then the gain to the recipient of the other property or money is to be recognized, but not in an amount exceeding the fair market value of such other property or money. Additionally, any gain realized on a section 1031 exchange must be recognized to the

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[427] Sec. 1411(c)(1)(A)(iii).

[428] The tax does not apply to a nonresident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

[429] Sec. 1031(a)(1).

[430] Sec. 1031(a)(2).

[431] Sec. 1031(e).

[432] Sec. 1031(h).

extent that the gain is subject to the recapture provisions of sections 1245 and 1250.[433] No losses may be recognized from a like-kind exchange.[434]

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.

The basis of like-kind property received in the exchange is the same as the basis of the property that was exchanged. This basis is increased to the extent of any gain recognized due to the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.[435] Thus, in the example 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). 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.[436]

Deferred like-kind exchanges.−A like-kind exchange does not require that the properties be exchanged simultaneously. Rather, the Code requires that the property to be received in the exchange 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).[437] 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.[438]

The Treasury Department has issued regulations[439] providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges. These regulations allow a taxpayer who wishes to sell appreciated property and reinvest the proceeds in other like-kind property to engage in "three-way" exchanges. For example, if taxpayer A wishes to sell his appreciated apartment building and acquire a commercial building, taxpayer A may transfer his apartment building to buyer B. Buyer B (directly or through an intermediary) agrees to purchase from owner C the commercial building that taxpayer A has designated. Buyer B then transfers title to

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[433] Secs. 1245(b)(4), 1250(d)(4).

[434] Sec. 1031(c).

[435] Sec. 1031(d).

[436] Sec. 1223(1).

[437] Sec. 1031(a)(3).

[438] *Ibid.*

[439] Treas. Reg. sec. 1.1031(k)-1(a) through (o).

the newly acquired commercial building to taxpayer A, completing the tax-free like-kind exchange. The economics of these transactions (taxes aside) are the same as if taxpayer A had sold the apartment building to buyer B and used the proceeds to purchase the commercial building from owner C. However, a transaction in which the taxpayer receives the proceeds of the sale and subsequently purchases like-kind property would be taxable to the taxpayer under general tax principles.

In order for a three-way exchange to qualify for tax-free treatment, the regulations prescribe detailed rules regarding identification of the replacement property, rules allowing the seller to receive security for performance by the buyer without the seller being technically in receipt of money or other property, and rules relating to whether a person is an agent of the taxpayer or is a qualified intermediary whose receipt of money or other property is not attributed to the taxpayer.

Involuntary conversions

In general.−Although gain or loss realized from the sale or other disposition of property must generally be recognized, section 1033 of the Code provides an exception to this rule in the case of certain involuntary conversions of property. Section 1033 applies if property is involuntarily or compulsorily converted into similar property or money. Such a conversion may occur as a result of the property's destruction (in whole or in-part), theft, seizure, requisition or condemnation or a sale made under the threat of requisition or condemnation.[440]

For purposes of section 1033, "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation.[441] Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or a threat of imminence thereof), and the divestiture is not eligible for deferral under this provision.[442]

If property is involuntarily converted into property that is similar or related in service or use to the property so converted, no gain is recognized. This treatment is not elective. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. If the taxpayer receives money (for instance, insurance payments or condemnation awards), or other dissimilar property for the involuntarily converted property, and acquires qualified replacement property within the prescribed time period, nonrecognition of the gain is optional.[443] As a

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[440] Sec. 1033(a).

[441] Rev. Rul. 58-11, 1958-1 C.B. 273.

[442] *Ibid*. If the replacement property is stock of a corporation and if the stock basis is decreased under this rule, the aggregate basis of the corporation's assets is likewise decreased by the same amount (but not below that stock basis as so decreased). Sec. 1033(b)(3).

[443] Sec. 1033(a)(2)(A).

general matter, the prescribed time period begins on the date of the disposition of the converted property (or threat or imminence of a threat of condemnation begins) and ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.[444]

The taxpayer's basis in the replacement property is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.[445]

For example, if under the threat of condemnation, a taxpayer sells for $35,000 a parcel of land C in which he has an adjusted basis of $25,000, and the taxpayer did not acquire property that is similar or related in service or use to the condemned parcel, the taxpayer would recognize $10,000 in gain. However, if within the prescribed time period described above, the taxpayer acquires a parcel of land D that is similar or related in service or use to C for $35,000, the taxpayer may elect not to recognize the $10,000 in gain from the sale of C. If the taxpayer so elects, his basis in D in would be $25,000, and any gain would be deferred until the taxpayer disposed of D in a recognition transaction. If, on the other hand, the taxpayer had acquired D for only $30,000, even if the taxpayer elected not to recognize gain on the transaction, the taxpayer would nevertheless recognize $5,000 in gain (representing the $5,000 in cash the taxpayer received from the $35,000 sale price of C less the $30,000 purchase price of D). The taxpayer's basis in D would remain $25,000 (having been adjusted upwards by $5,000 to reflect the amount of gain recognized on the conversion, and then having been adjusted downwards by $5,000 to reflect cash received in the conversion). If the taxpayer subsequently sells D for at least $30,000, this would trigger the remaining $5,000 in deferred gain.

Treatment of losses.−Section 1033 does not, by its terms, apply to losses realized from the involuntary conversion of property.

Sales of qualified small business stock

Nonrecognition in the event of rollover.−Section 1045 provides for elective nonrecognition of capital gain on the sale of certain qualified small business stock held by a taxpayer other than a corporation for more than six months if the taxpayer rolls that gain over into new qualified small business stock within a 60-day period beginning on the date of sale. Qualified small business stock is any stock in a C corporation (originally issued after August 10, 1993), if, as of the date of issuance, the corporation is a qualified small business, and the stock is acquired by the taxpayer at original issue in exchange for money or property, or as compensation for services provided to the corporation.[446] The term qualified small business refers to any domestic C corporation that has aggregate gross assets that, at all times on or after August 10, 1993, through and immediately following the issuance of the qualified small business stock, do

[444] Sec. 1033(a)(2)(B).

[445] Sec. 1033(b).

[446] Sec. 1202(c)(1).

not exceed $50 million, and such corporation agrees to submit reports to the Treasury Department and its shareholders as may be required by the Secretary of the Treasury.[447]

Stock in a corporation may not be treated as qualified small business stock unless, during the first six months of the taxpayer's holding period,[448] it satisfies the active business requirement. To meet this test, at least 80 percent of the corporation's assets must be used in the "active conduct" of one or more trades or businesses other than specifically enumerated trades or businesses.[449] Additionally, such corporation must be an eligible corporation, meaning that it may not be a domestic international sales corporation ("DISC"), a corporation with respect to which an election under section 936 is in effect, a regulate investment corporation ("RIC"), real estate investment trust ("REIT"), real estate mortgage investment conduit ("REMIC"), or a cooperative.

If the above conditions are satisfied, and the taxpayer so elects, the taxpayer recognizes gain from the sale of the qualified small business stock only to the extent that the amount realized on the sale of the qualified small business stock exceeds the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of the sale (reduced by any portion of that cost already used to shelter the amount realized with respect to the sale of other qualified small business stock).[450] To the extent that gain is not recognized, the taxpayer reduces his basis in the newly purchased qualified small business stock.

For example, if a taxpayer acquires qualified small business stock for $50,000, and one year later, having met all of the requisites described above, sells the qualified small business stock for $60,000, the taxpayer would not need to recognize the $10,000 gain if within the 60-day period following the sale of the qualified small business stock the taxpayer purchased $60,000 of qualified small business stock of another issuer. The taxpayer's basis in the new qualified small business stock would be $50,000 (*i.e.*, the purchase price of the new qualified small business stock reduced by the $10,000 of unrecognized gain). If the taxpayer instead had purchased only $50,000 of qualified small business stock of another issuer, however, the

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[447] Sec. 1202(d).

[448] The six-month holding period requirement varies from the active business requirement under section 1202, discussed below, which requires that the stock meet the active business requirement for "substantially all" the taxpayer's holding period.

[449] Sec. 1202(e)(3). Trades or businesses listed as nonqualifying are: (1) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees; (2) banking insurance financing, leasing, investing, or similar business; (3) any farming business (including the business of raising or harvesting trees); (4) any business involving the production or extraction of products with respect to which a deduction is allowable under sections 613 or 613A *(i.e.*, natural resource extraction); and (5) any business of operating a hotel, motel, restaurant, or similar business.

[450] The effect of this rule is to disallow multiple nonrecognition rollovers of QSBS on the same economic gain.

taxpayer would be required to recognize the $10,000 of gain on the sale of his initial qualified small business stock.

10. Treatment of partnership carried interests under present law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.[451]

In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profit interest for services as not a taxable event for the partnership or the partner.[452] 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[453] clarifies that this treatment applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[454]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[455] A partnership capital interest for this purpose is an interest that

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[451] 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)).

[452] Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

[453] 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.

[454] 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).

[455] 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).

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.[456]

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). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[457] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[458] The proposed regulations

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[456] Rev. Proc. 93-27, 1993-2 C.B. 343.

[457] Sec. 83(h).

[458] 70 Fed. Reg. 29675 (May 24, 2005).

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 transfer 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 transfer), under the proposed regulations, the transfer of a substantially vested profits interest (or, if a section 83(b) election is made, the transfer of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[459] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Employment tax treatment of partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[460] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[461]

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[459] Sec. 702.

[460] See Chapter 21 of the Code.

[461] Sec. 1401.

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent,[462] half of which is imposed on the employer, and the other half of which is imposed on the employee.[463] The amount of wages subject to this component is capped at $113,700 for 2013. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax (as well as the self-employment tax HI component) is increased by an additional tax of 0.9 percent on wages and self-employment income received in excess of a specific threshold amount.[464] The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[465]

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $113,700 for 2013. Under the HI component, the rate is 2.9 percent,[466] and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax

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[462] A temporary reduction, expiring December 31, 2012, (1) applied a reduced OASDI tax rate of 4.2 percent for employees, and (2) applied a reduced OASDI tax rate of 10.4 percent for self-employed individuals through 2012 (with a related adjustment to the deduction for one-half of SECA tax). The temporary reduction was enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, through December 31, 2011, and was extended through February 29, 2012, by the Temporary Payroll Tax Cut Continuation Act of 2011, Pub. L. No. 112-78, and through December 31, 2012, by the Middle Class Tax Relief and Job Creation Act of 2012, Pub. L. No. 112-96.

[463] Secs. 3101 and 3111.

[464] Secs. 3101(b)(2) and 1401(b)(2). Unlike the general 1.45 percent HI tax on wages, the additional 0.9 percent tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarried individual or head of household).

[465] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or whether some portion is properly characterized as another type of income (typically, the shareholder's distributive share) and therefore not subject to FICA tax. Case law addressing this issue includes *David E. Watson, P.C., v. U.S.*, 668 F.3d 1008 (8th Cir. 2012); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, *Joseph M. Grey Public Accountant, P.C., v. Commissioner*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473 (3d Cir. 2004), and *Nu-Look Design, Inc. v. Commisioner*, 356 F.3d 290 (3d Cir. 2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[466] Sec. 1401; an additional 0.9 percent tax applies for remuneration received in taxable years beginning after December 31, 2012 (sec. 1401(b)(2)).

rules.[467] Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.[468]

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[469] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[470]

Tax on net investment income

For taxable years beginning after 2012, in the case of an individual, estate, or trust, a tax is imposed on net investment income.[471] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[472] over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

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[467] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[468] Secs. 1402(a)(1), (2), and (3).

[469] Sec. 1402(a)(13).

[470] In *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136. T. C. 137 (2012), the Tax Court held that the section 1402(a)(13) limited partner exception did not apply to the distributive shares of partners performing legal services in a law partnership.

[471] Sec. 1411.

[472] Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1), net of the deductions and exclusions disallowed with respect to foreign earned income.

11. New markets tax credit ("NMTC")

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[473] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.[474] The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.[475] 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.[476]

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE.[477] A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.[478] Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.[479]

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[473] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554.

[474] Sec. 45D(a)(2).

[475] Sec. 45D(a)(3).

[476] Sec. 45D(g).

[477] Sec. 45D(c).

[478] Sec. 45D(b).

[479] Sec. 45D(d).

A low-income community is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income.[480] For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary is authorized to designate targeted populations as low-income communities for purposes of the new markets tax credit.[481] For this purpose, a targeted population is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994[482] (the "Act") to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that low-income means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of—80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.[483] A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391 of the Code, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of the business is used in a low-income community; (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.[484]

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[480] Sec. 45D(e).

[481] Sec. 45D(e)(2).

[482] Pub. L. No. 103-325.

[483] Pub. L. No. 103-325.

[484] Sec. 45D(d)(2).

The new markets tax credit is extended by the American Taxpayer Relief Act of 2012[485] for two years, through 2013, permitting up to $3.5 billion in qualified equity investments for each of the 2012 and 2013 calendar years. That legislation also extends for two years, through 2018, the carryover period for unused new markets tax credits.

[485] Pub. L. No. 112-240, sec. 305, January 2, 2013.

C. Present Law: Education and Family Benefits

1. Overview of tax benefits for individuals who incur education expenses

Present and recently expired law includes a variety of provisions that provide tax benefits to individual taxpayers for education expenses. These provisions include tax benefits for current expenses, such as the American Opportunity, Hope, and Lifetime Learning credits,[486] the above-the-line deduction for certain higher education expenses,[487] and the exclusions for employer-provided education assistance and scholarships.[488] Present law also includes tax benefits for saving for future education expenses, including qualified tuition programs[489] and Coverdell education savings accounts.[490] In addition, individuals may use for education expenses funds accumulated on a tax-favored basis through the use of other savings vehicles, such as IRAs and health savings accounts, even though these vehicles are not designed specifically for education expenses. However, additional taxes may apply in that case. Finally, tax benefits are provided for past expenses through the allowance of a deduction for the payment of certain student loan interest and an income exclusion for the value of certain cancelled student loan indebtedness.[491] These provisions, and other provisions relating to education, are discussed in more detail, below.

If an individual does not qualify for any of the specific tax benefits for higher education expenses, then the individual generally may not deduct such expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.[492] Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's AGI.[493] A taxpayer's total itemized deductions,

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[486] Sec. 25A. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended ("Code").

[487] Sec. 222. This provision was available for taxable years beginning before January 1, 2012. Sec. 222(e).

[488] Secs. 127 and 117, respectively.

[489] Sec. 529.

[490] Sec. 530.

[491] Secs. 221 and 108(f), respectively.

[492] Treas. Reg. sec. 1.162-5.

[493] Sec. 67.

including miscellaneous deductions in excess of two percent of AGI, may be further limited by the overall limit on itemized deductions that applies if AGI exceeds certain amounts.[494]

2. Tax benefits for current expenses

Hope Credit and American Opportunity Credit

Hope credit

For taxable years beginning before 2009 and after 2017, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,800 (estimated 2013 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[495] The Hope credit rate is 100 percent on the first $1,200 of qualified tuition and related expenses, and 50 percent on the next $1,200 of qualified tuition and related expenses. These dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income ("AGI") phaseout described below) for a $1,200 Hope credit. If a taxpayer incurs $2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for an $1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified aggregate gross income ("AGI") between $53,000 and $63,000 ($106,000 and $126,000 for married taxpayers filing a joint return), as estimated by the JCT staff for 2013. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phaseout ranges for single and married taxpayers are always $10,000 and $20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

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[494] Sec. 68.

[495] Sec. 25A. For taxable years 2009-2017, the American Opportunity credit applies (discussed *infra*). The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, both the Hope credit and the American Opportunity credit (in the case of taxable years from 2009-2017) may be claimed against a taxpayer's alternative minimum tax liability.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may claim only one of the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony for the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

American Opportunity credit

The American Opportunity credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009-2017. The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

The modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Lifetime Learning Credit

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.[496] Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is $2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

In contrast to the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the Hope credit is computed on a per student basis while the Lifetime

[496] Sec. 25A. The Lifetime Learning credit may be claimed against a taxpayer's alternative minimum tax liability.

Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $53,000 and $63,000 ($107,000 and $127,000 for married taxpayers filing a joint return) in 2012. These phaseout ranges are the same as those for the Hope credit as it applies for tax years beginning before 2009 and after 2017, and are similarly indexed for inflation.

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. As with the Hope and American Opportunity credits, qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. Repayment of a loan is not a qualified tuition expense.

As with the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by a parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a Hope or American Opportunity tax credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope or American Opportunity tax credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the Hope and American Opportunity tax credits, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses (described below).

As with the Hope credit, the Lifetime Learning credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. However, unlike the American Opportunity tax credit, the Lifetime Learning credit is not available for the expenses of course materials. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the Lifetime Learning credit. Expenses involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program, or the education is undertaken to acquire or improve the job skills of the student.

Qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.[497] Additionally, in contrast to the Hope and American Opportunity tax credits, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

As with the Hope and American Opportunity tax credits, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

Above-the-Line Deduction for Certain Higher Education Expenses

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[498] Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, and include tuition and fees required for the enrollment or attendance by the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.[499] The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose AGI for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose AGI does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption

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[497] As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education. The American Opportunity tax credit is available only with respect to the first four years of a student's post-secondary education.

[498] Sec. 222.

[499] The deduction generally is not available for expenses with respect to a course of education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2013.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,[500] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[501] Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for an exclusion under section 222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope, American Opportunity, or Lifetime Learning credit is elected for such taxable year.

Exclusion for Employer-Provided Educational Assistance

If certain requirements are satisfied, up to $5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes.[502] This exclusion applies to both graduate and undergraduate courses. For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more-than-five-percent owners of the employer and the spouses or dependents of such more-than-five-percent owners.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, and (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (*i.e.*, it does not apply to education provided to the spouse or a child of the employee).

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[500] Sec. 222(d)(1).

[501] Sec. 222(c). These reductions are the same as those that apply to the Hope, American Opportunity, and Lifetime Learning credits.

[502] Secs. 127, 3121(a)(18).

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit—that is, the expenses would have been deductible by the employee (if paid by the employee) under section 162 (as discussed above).[503] In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

Qualified Scholarships and Tuition Reduction

Present law provides an exclusion from gross income and wages for amounts received as a qualified scholarship by an individual who is a candidate for a degree at a qualifying educational organization.[504] In general, a qualified scholarship is any amount received by such an individual as a scholarship or fellowship grant if the amount is used for qualified tuition and related expenses. Qualified tuition and related expenses include tuition and fees required for enrollment or attendance, or for fees, books, supplies, and equipment required for courses of instruction, at the qualifying educational organization. This definition does not include regular living expenses, such as room and board. A qualifying educational organization is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.[505]

In addition to the exclusion for qualified scholarships, present law provides an exclusion from gross income and wages for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.[506]

The exclusions for qualified scholarships and qualified tuition reductions do not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Services Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program"). An additional exception to this rule, only with respect to qualified tuition reductions, is the exclusion of such qualified tuition reductions from income in the case of a graduate student

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[503] Sec. 132(d).

[504] Secs. 117(a), 3121(a)(20).

[505] This definition is different from the educational institutions whose students are eligible for the Hope, American Opportunity and Lifetime Learning credits, and the expired deduction for qualified tuition expenses. Eligible institutions for purposes of those credits and deductions must be eligible to participate in a student aid program administered by the U.S. Department of Education, while educational institutions for purposes of qualified scholarships and tuition do not have such a requirement. IRS Publication 970, p. 11 (2012). Additionally, an educational institution for purposes of the exclusion of qualified scholarships and tuition reduction is not limited to post-secondary educational institutions.

[506] Secs. 117(d), 3121(a)(20).

at an educational organization described in section 170(b)(1)(A)(ii) who is engaged in research or teaching activities for the organization.[507] Such a tuition reduction is excluded from income despite the general rule described above, *i.e.*, that payments for such services are includible in gross income and wages.

Dependency Exemption for Students Ages 19-23

Under present law, taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. The amount of these personal exemptions is adjusted annually for inflation. For 2013, the exemption amount is $3,900. The deduction for personal exemptions is phased out for taxpayers with incomes above $250,000 ($300,000 in the case of joint-filers).[508]

A taxpayer may claim an exemption deduction for each individual the taxpayer claims as a dependent who is a qualifying child. For an individual to meet the definition of a qualifying child, that person must meet five tests, bearing on (1) relationship; (2) age; (3) principal place of abode; (4) support; and (5) whether the individual being claimed as a dependent has filed a joint return.

As a general matter, the age test provides that an individual may be considered a qualifying child (and thus be eligible to be claimed for a dependency exemption deduction) only if such an individual is under the age of 19 at the end of the calendar year.[509] However, a special rule provides that an individual who is under the age of 24 at the end of the calendar year will qualify as a qualifying child (provided that the individual meets the other criteria) if that individual is a student during the calendar year.

A student is defined as an individual who during each of five calendar months during the calendar year is: (1) a full-time student at an educational organization described in section 170(b)(1)(A)(ii) of the Code (*i.e.*, an institution that normally maintains regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on),[510] or (2) is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii) of the Code, or of a State or political subdivision of a State.[511]

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[507] Sec. 117(d)(5).

[508] Sec. 151(d)(3).

[509] Sec. 152(c)(3)(A).

[510] This is the same definition as is used for purposes of the exclusion for qualified scholarships and tuition reduction (and different from the definition used for the Hope, American Opportunity, and Lifetime Learning credits, as well as the expired deduction for qualified tuition expenses).

[511] Sec. 152(f).

Gift Tax Exclusion for Educational Expenses

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to $14,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.[512]

In addition to the gift tax annual exclusion, the Code provides that certain tuition payments are not considered transfers of property by gift for gift tax purposes.[513] This exclusion covers amounts paid on behalf of an individual as tuition to an educational organization described in section 170(b)(1)(A)(ii) (*i.e.*, an institution that normally maintains regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on) for the education or training of such individual. No unlimited exclusion is permitted for books, supplies, dormitory fees, board, or other similar expenses that do not constitute direct tuition costs.[514] The exclusion applies only to direct transfers to the educational institution, not to reimbursements to donees for amounts paid by them for otherwise qualifying services, or to trusts to provide for the education of designated beneficiaries.[515] This exclusion applies without regard to the relationship of the donor and donee.

3. Tax benefits for saving for education expenses

Section 529 Qualified Tuition Programs

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[516] 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"). 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

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[512] The Code provides an amount of $10,000, adjusted in $1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2013 is $14,000.

[513] Sec. 2503(e).

[514] Treas. Reg. sec. 25.2503-6(b)(2).

[515] Treas. Reg. sec. 25.2503-6(c), ex. 2.

[516] 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.

"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.

For this purpose, 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,[517] 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.[518]

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), 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.

Distributions from a qualified tuition program are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary. If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over without income tax liability to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

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

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[517] The definition of an eligible educational institution for purposes of qualified higher education expenses is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits and the expired deduction for qualified tuition expenses. See fn. 25, *supra*.

[518] For taxable years 2009 and 2010 only, qualified higher education expenses included the purchase of any computer technology or equipment, or internet access or related services, if such technology or services were to be used by the beneficiary or the beneficiary's family during any of the years a beneficiary was enrolled at an eligible institution.

for the benefit of a designated beneficiary. Decisions with respect to the contract or account are 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")[519] 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.

Coverdell Education Savings Accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[520] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.[521] However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (*i.e.*, the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[522]

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell

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[519] 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.

[520] Sec. 530.

[521] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

[522] This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include qualified elementary and secondary expenses and qualified higher education expenses. The term qualified elementary and secondary school expenses, means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

The term qualified higher education expenses includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution,[523] regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.[524] Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.[525]

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational

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[523] The definition of an eligible educational institution for purposes of qualified higher education expenses is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits and the expired deduction for qualified tuition expenses. See fn. 25, *supra*.

[524] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

[525] Sec. 530(b)(2)(B).

benefits, such as employer-provided educational assistance, that are excludable from the employee's gross income under section 127.

Exclusion of Interest Earned on Education Savings Bonds

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[526] Qualified higher education expenses include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain eligible higher educational institutions.[527] The amount of qualified higher education expenses taken into account for purposes of the exclusion is reduced by the amount of such expenses taken into account in determining the Hope, American Opportunity, or Lifetime Learning credits claimed by any taxpayer, or taken into account in determining an exclusion from gross income for a distribution from a qualified tuition program or a Coverdell education savings account, with respect to a particular student for the taxable year.[528]

The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 2013, the exclusion is phased out for taxpayers with modified AGI between $74,000 and $89,700 ($112,050 and $142,050 for married taxpayers filing a joint return). To prevent taxpayers from effectively avoiding the income phaseout limitation through the purchase of bonds directly in the child's name, the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Other Tax-Favored Savings Arrangements

Present law also provides vehicles for tax-favored saving for purposes other than education, such as for retirement (for example, qualified retirement plans and individual retirement arrangements) or health expenses (for example, health savings accounts). Despite these intended purposes, as a practical matter, the funds in such arrangements are sometimes used for education expenses, though additional taxes may apply in that case.[529] However, distributions from an individual retirement arrangement ("IRA") for qualified higher education

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[526] Sec. 135. If the aggregate redemption amount (*i.e.*, principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bear to the aggregate redemption amount.

[527] The definition of eligible higher educational institution for purposes of qualified higher education expenses is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits and the expired deduction for qualified tuition expenses.

[528] Additionally, educational expenses taken into account in determining the interest exclusion were not eligible for the recently-expired deduction for qualified tuition and related expenses under section 222.

[529] See, *e.g.*, secs.72(t) and 223(f)(4).

expenses may be taken without having to pay the additional tax.[530] For more information on retirement savings arrangements, see Joint Committee on Taxation, Present Law and Background Relating to the Tax Treatment of Retirement Savings (JCX-32-12), April 13, 2012.

4. Tax benefits relating to past expenses (student loans)

Deduction for Student Loan Interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.[531] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions,[532] or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is $2,500. For 2012, the deduction is phased out ratably for taxpayers with AGI between $60,000 and $75,000 ($125,000 and $155,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

5. Exclusion of income from student loan forgiveness

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

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[530] Sec. 72(t)(2)(E).

[531] Sec. 221.

[532] This definition of an eligible educational institution is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits, and the expired deduction for qualified tuition expenses. See fn. 25, *supra*.

student's working for a certain period of time in certain professions for any of a broad class of employers.[533]

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.[534] 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 upon 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 or certain State loan repayment programs.

6. Tax benefits related to families

Tax Benefits Relating To Children

In general

Present law contains five commonly used provisions that provide benefits to taxpayers with children: (1) the child credit; (2) the dependency exemption; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. Prior to the enactment of the Working Families Tax Relief Act of 2004, each provision had separate criteria for

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[533] Sec. 108(f).

[534] This definition of eligible educational institution is the same definition as is used for purposes of the exclusion for qualified scholarships and tuition reduction (and different from the definition used for the Hope, American Opportunity, and Lifetime Learning credits, as well as the expired deduction for qualified tuition expenses).

determining whether the taxpayer qualified for the applicable tax benefit with respect to a particular child. That Act modified the Code so as to provide for a uniform definition of a child for all of those provisions.

Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Residency test

Under the residency test, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Special rules apply in the case of divorced or separated parents (discussed below).

Relationship test

The relationship test requires that the individual is the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (for example, the taxpayer's grandchild). Additionally, the child can be the taxpayer's brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them (for example, the taxpayer's niece or nephew). For purposes of determining whether an adopted child is treated as a child by blood, an adopted child qualifies if he or she is an individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.

Age test

The age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child. In general, no age limit applies with respect to individuals who are totally and permanently disabled at any time during the calendar year. Important exceptions to this general rule are: (1) a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit and (2) a child must be under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

A child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. However, a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income credit.

Tie-breaking rules

If a child would be a qualifying child with respect to more than one individual (*e.g.*, a child lives with his or her mother and grandmother in the same residence) and more than one

person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time, and second with respect to the parent with the highest adjusted gross income. Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

Citizenship and residency

Children who are not a citizen or nationals of the United States cannot qualify as a qualifying child, unless such children are resident in the United States, Canada or Mexico. A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a qualifying child (provided other applicable requirements are met) 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.

Children of divorced or legally separated parents

Special rules apply in the case of a child of divorced or legally separated parents (or parents who live apart at all times during the last six months of the year) who provide over one half the child's support during the calendar year.[535] If such a child is in the custody of one or both of the parents for more than one half of the year, then the parent having custody for the greater portion of the year is deemed to satisfy the support test; however, the custodial parent may release the claim to a dependency exemption (and, therefore, the child credit) to a noncustodial parent. There is an additional custodial waiver rule for purposes of the dependency exemption (and, therefore, the child credit) for decrees of divorce or separate maintenance or written separation agreements. The custodial waiver rules do not affect eligibility with respect to children of divorced or legally separated parents for purposes of the earned income credit, the dependent care credit, and head of household filing status.

Identification requirements

The Code that a taxpayer identification number for a child be provided on the taxpayer's return. For purposes of the earned income credit, a qualifying child is required to have a Social Security number that is valid for employment in the United States (that is, the child must be a U.S. citizen, permanent resident, or have a certain type of temporary visa).

[535] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child or foster child, or child placed with the taxpayer for adoption).

Child credit

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

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income 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 adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against both the regular tax and the alternative minimum tax ("AMT"). To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit[536] (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). Prior to the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the threshold dollar amount was $10,000 and was indexed for inflation. Under the ARRA, the threshold amount (beginning in 2009 and 2010) was $3,000 (the $3,000 amount is not indexed). The $3,000 threshold is currently scheduled to expire for taxable years beginning after December 31, 2017, after which the threshold reverts to the indexed $10,000 amount ($13,350 for 2013).

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

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the

[536] The refundable credit may not exceed the maximum credit per child of $1,000.

amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Dependent exemption

Taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. The deduction for personal exemptions is phased out for taxpayers with AGI above $250,000 ($300,000 in the case of joint-filers). For 2013, the dependent exemption is $3,900 per dependent.

Earned income credit

Overview

Low- and moderate-income workers may be eligible for the refundable earned income credit ("EIC"). Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income ("AGI"), if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,300 (for 2013). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter,

stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.[537] The values below are for 2013.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $6,370, resulting in a maximum credit of $487. The maximum is available for those with incomes between $6,210 and $7,970 ($13,310 if married filing jointly). At that point, the credit begins to phase out at a rate of 7.65 percent of earnings above that threshold, resulting in a $0 credit at $14,340 of earnings ($19,680 if married filing jointly).

Taxpayers with one qualifying child may claim a credit of 34 percent of their earnings up to $9,560, resulting in a maximum credit of $3,250. The maximum credit is available for those with earnings between $9,560 and $17,530 ($22,870 if married filing jointly). At that point, the credit begins to phase out at a rate of 15.98 percent of earnings above this threshold, phasing out completely at $37,870 of earnings ($43,210 if married filing jointly).

Taxpayers with two qualifying children may claim a credit of 40 percent of earnings up to $13,430, resulting in a maximum credit of $5,372. The maximum credit is available for those with earnings between $13,430 and $17,530 ($22,870 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at $43,038 of earnings ($48,378 if married filing jointly).

A temporary provision recently extended by the American Taxpayer Relief Act of 2012 allows taxpayers with three or more qualifying children to claim a credit of 45 percent for taxable years before 2018. Thus, in 2013 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $13,430, resulting in a maximum credit of $6,044. The maximum credit is available for those with earnings between $13,430 and $17,530 ($22,870 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and are completely phased out at $46,227 of earnings ($51,567 if married filing jointly).

A temporary provision recently extended by the American Taxpayer Relief Act of 2012 increases the phase-out thresholds for married couples to an amount $5,000 (indexed for inflation from 2009)[538] above that for other filers. The increase is $5,340 for 2013.

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[537] All income thresholds are indexed for inflation annually.

[538] A technical correction may be necessary to reflect that the $5,000 amount is indexed.

Dependent care

Dependent care credit

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 35 percent of a limited amount of employment-related dependent care expenses. Eligible child and dependent care expenses related to employment are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals. The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000. Thus, for taxpayers with adjusted gross income above $43,000, the credit rate is 20 percent. The phase-out point and the amount of expenses eligible for the credit are not indexed for inflation.

Generally, a qualifying individual is: (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption, or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit.

Exclusion of employer-provided child or dependent care services

Up to $5,000 annually of employer-provided dependent care assistance is excludable from gross income and wages if the assistance is provided pursuant to a separate written plan of an employer that does not discriminate in favor of highly compensated employees and meets certain other requirements. The amount excludable cannot exceed the earned income of the employee or, if the employee is married, the lesser of the earned income of the employee or the earned income of the employee's spouse.

Head of household filing status

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half the year of (1) a qualifying child, or (2) an individual for whom the taxpayer may claim a dependency exemption. A taxpayer may claim head of household status with respect to a parent for whom the taxpayer may claim a dependency exemption and who does not live with the taxpayer, if certain requirements are satisfied.

Taxpayers who file as heads of household compute their tax under the same rate structure as all other taxpayers, however the bracket breakpoints for heads of household are higher than that for other unmarried taxpayers and lower than that for married taxpayers filing jointly (other than the beginning of the 35-percent bracket breakpoint, which is the same for all filing statuses).

7. Other tax-provisions related to families

Benefits Related to Adoption

Adoption credit

In general

A tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer subject to a maximum credit amount per eligible child.[539] An eligible child is an individual who: (1) has not attained age 18; or (2) is physically or mentally incapable of caring for himself or herself. The maximum credit is applied per child rather than per year. Therefore, while qualified adoption expenses may be incurred in one or more taxable years, the tax credit per adoption of an eligible child may not exceed the maximum credit.

For taxable years beginning in 2013, the maximum credit amount is $12,970, and the credit is phased out ratably for taxpayers with modified adjusted gross income above a certain amount. In 2013, the phase out range begins at modified adjusted gross income of $194,580, with no credit allowed for taxpayers with a modified adjusted gross income of $234,580. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands and residents of Puerto Rico, respectively).

Special needs adoptions

In the case of a special needs adoption finalized during a taxable year, the taxpayer may claim as an adoption credit the amount of the maximum credit minus the aggregate qualified adoption expenses with respect to that adoption for all prior taxable years. A special needs child is an eligible child who is a citizen or resident of the United States whom a State has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

Qualified adoption expenses

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of State or Federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child of the taxpayer's spouse; and (4) not reimbursed (*e.g.*, by an employer).

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[539] Sec. 36C.

Exclusion for employer-provided adoption assistance

An exclusion from the gross income of an employee is allowed for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. For 2013, the maximum exclusion is $12,970. Also for 2013, the exclusion is phased out ratably for taxpayers with modified adjusted gross income between $194,580 and $234,580. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For purposes of this exclusion, modified adjusted gross income also includes all employer payments and reimbursements for adoption expenses whether or not they are taxable to the employee.

Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

Benefits Related to Health Care and Dependent Care

Dependent care flexible spending arrangements

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee receives certain nontaxable employer-provided benefits, including dependent care assistance. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction.[540] FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (*e.g.*, the exclusion for dependent care assistance). If the applicable requirements are satisfied, contributions to the FSA and all distributions to pay dependent care expenses are excludable from income and from wages for FICA tax purposes.

Credit for coverage under a qualified health plan

Certain taxpayers may claim a refundable tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through an exchange.[541] The premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an exchange.

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[540] Sec. 125.

[541] Individuals enrolled in multi-state plans are also eligible for the credit.

The premium assistance credit is available for individuals (single or joint filers) with household incomes between 100 and 400 percent of the Federal poverty level ("FPL") for the family size involved who do not received health insurance through an employer or a spouse's employer.[542] Household income is defined as the sum of: (1) the taxpayer's modified adjusted gross income, plus (2) the aggregate modified adjusted gross incomes of all other individuals taken into account in determining that taxpayer's family size (but only if such individuals are required to file a tax return for the taxable year). Modified adjusted gross income is defined as adjusted gross income increased by: (1) the amount (if any) normally excluded by section 911 (the exclusion from gross income for citizens or residents living abroad), plus (2) any tax-exempt interest received or accrued during the tax year. To be eligible for the premium assistance credit, taxpayers who are married (within the meaning of section 7703) must file a joint return. Individuals who are listed as dependants on a return are ineligible for the premium assistance credit.

Benefits Related to the Gift Tax

Annual gift tax exclusion

A gift tax is generally imposed on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities.

Annual gifts of $14,000 (for 2013) or less per donor and per donee generally are not subject to tax. The amount of the annual gift tax exclusion is indexed for inflation.

Gift tax exclusion for medical expenses

A gift tax is imposed on transfers of property by gift, subject to several exceptions. One exception is the gift tax annual exclusion of section 2503(b), described above. In addition to the gift tax annual exclusion, the Code provides that payments of medical expenses are not considered transfers of property by gift for gift tax purposes.[543] This exclusion covers amounts paid (a) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purposes of affecting any structure or function of the body; (b) for transportation primarily for and essential in medical care referred to in (a); (c) for qualified long-term care services; or (d) for insurance (including amounts paid as premiums under Part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in (a) and (b) or for any qualified long-term care insurance contract.

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[542] Individuals who are lawfully present in the United States but are not eligible for Medicaid because of their immigration status are treated as having a household income equal to 100 percent of FPL (and thus eligible for the premium assistance credit) as long as their household income does not actually exceed 100 percent of FPL.

[543] Sec. 2503(e).

Gift tax deduction for spousal gifts

The value of a gift made from one spouse to another is deductible in computing the donor's taxable gifts. This deduction effective exempts such gift from the gift tax.

D. Present Law: Energy

1. Extraction and production

Summary of Fossil Fuel Capital Cost Recovery Provisions

Eligible Activity	Description of Provision	Expiration
Geological & geophysical expenditures (sec. 167(h))	• Geological and geophysical ("G&G") expenditures incurred by independent producers and smaller integrated oil companies in connection with domestic oil and gas exploration may be amortized over 24 months. • G&G expenditures incurred by major integrated oil companies are amortized over seven years. • Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts. A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more. • In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property, but instead must continue to be amortized over the remaining applicable amortization period.	None
Election to expense 50 percent of qualified property used in refining liquid fuels (sec. 179C)	Taxpayers may elect to expense 50 percent of the cost of qualified refinery property used for processing liquid fuel from crude oil or qualified fuels; the remaining 50 percent is recovered under otherwise applicable rules.	December 31, 2013
Deduction for tertiary injectants (sec. 193)	Taxpayers engaged in petroleum extraction activities generally may currently deduct qualified tertiary injectant expenses paid or incurred while applying a tertiary recovery method.	None

Eligible Activity	Description of Provision	Expiration
Election to expense intangible drilling costs (secs. 263(c) and 291)	• Taxpayers may elect to currently deduct intangible drilling costs ("IDCs") paid or incurred with respect to the development of an oil or gas property located in the United States. • For an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period. Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.	None
Depletion (secs. 611-613A and 291)	• Depletion is available to any person having an economic interest in a producing mine or oil and gas property. There generally are two types of depletion--cost and percentage depletion. • Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year relative to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. • Under the percentage depletion method, a percentage, varying from five percent to 22 percent (generally 15 percent for oil and gas properties), of the taxpayer's gross income from a producing property is allowed as a deduction in each taxable year. The amount deducted generally may not exceed 50 percent (100 percent in the case of oil and gas properties) of the net income from the oil and gas property in any year (the "net-income limitation"). • Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction and adjusted for certain loss carrybacks and trust distributions). • Cost depletion is limited to the taxpayer's basis in the property, whereas percentage depletion is not limited by the basis, but is subject to limitations based on net income derived from the property and taxable income.	None

Eligible Activity	Description of Provision	Expiration
	• Percentage depletion for producing oil and gas property (15 percent rate) is available only to independent producers and royalty owners. Integrated oil and gas companies must use cost depletion.[544] Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts. • Percentage depletion is also available for coal and lignite (10 percent rate)[545] and oil shale (15 percent rate).[546] The percentage depletion deduction for coal and lignite is generally reduced for corporations by an amount equal to 20 percent of the percentage depletion that exceeds the adjusted basis of the property.	
Development expenditures for hard mineral fossil fuels (secs. 616, 617, and 291)	• 70 percent of the costs paid or incurred for the development of a mine or other natural deposit (other than an oil or gas well) may be expensed. • The remaining 30 percent of costs must be capitalized and amortized over five years.	None

[544] Sec. 613A(c).

[545] Sec. 163(b)(4).

[546] Sec. 163(b)(2)(B).

Summary of Energy Credits Related to Fossil Fuel Production

Eligible Activity	Description	Credit Amount	Expiration
Enhanced oil recovery credit (sec. 43)	• Credit for expenses associated with an enhanced oil recovery ("EOR") project • An EOR project generally is a project that involves the use of one or more tertiary recovery methods to increase the amount of recoverable domestic crude oil	• 15 percent of EOR costs • Currently phased-out	None
Indian coal credit (sec. 45)	Production credit for coal produced at facilities placed in service before 2009 that produce coal from reserves that on June 14, 2005 were owned by (or held in trust on behalf of) an Indian tribe	• $2-per-ton credit (adjusted for inflation: $2.308 per ton for 2013)	December 31, 2013
Marginal wells credit (sec. 45I)	Production credit for marginal wells or wells that have an average daily production of not more than 25 barrels per day	• $3-per-barrel credit (adjusted for inflation from 2004) for the production of crude oil from marginal wells • $0.50-per-1,000-cubic-feet credit (adjusted for inflation from 2004) for the production of natural gas from a marginal wells • Currently phased-out	None
Mine rescue training credit (sec. 45N)	Credit for costs paid or incurred for training mine rescue team employees	• The lesser of 20 percent of the training program cost per employee or $10,000 per employee	December 31, 2013

Summary of Other Provisions Related to Fossil Fuels

Eligible Activity	Description	Expiration
Election to expense advanced mine safety equipment (sec. 179E)	• Taxpayers may elect to expense 50 percent of the cost of any qualified advanced mine safety equipment property. • Advanced mine safety equipment includes certain emergency communication technology, electronic identification and location devices, oxygen-generating, self-rescue devices, pre-positioned oxygen supplies, and comprehensive atmospheric monitoring systems.	December 31, 2013
Capital gains treatment of certain coal royalties (sec. 631(c))	• In the case of the disposal of coal (including lignite) mined in the United States, held for more than one year prior to disposal, by the owner in a form under which the owner retains an economic interest in such coal, the excess of the amount realized from the sale over the adjusted depletable basis of the coal (plus certain disallowed deductions) is treated as from the sale of property used in the owner's trade or business (*i.e.*, the sale of section 1231 property). • If the owner's net section 1231 gains, including royalties from eligible coal disposals, exceed its section 1231 losses, the royalties are treated as capital gains.	None
Passive loss rules for working interests in oil and gas property (sec. 469)	• Passive activity loss rules are not applicable to working interest in any oil or gas property that a taxpayer holds directly or indirectly through an entity that does not limit the taxpayer's liability. • Losses and credits from such interests, in general, may offset income from other activities of such taxpayer.	None

Eligible Activity	Description	Expiration
Last-in, first-out method of accounting for inventories (sec. 472)	• Under a last-in, first-out ("LIFO") method, the most recently acquired or produced units are deemed sold first. • Beneficial if the price of inventory is increasing because inflation is taken into account in computing current year taxable income. • An alternative method of accounting is the first-in, first-out ("FIFO") method, in which the earliest acquired or produced units are deemed sold first. • Used by many oil and gas companies, but use of a LIFO method is not limited to the energy sector.	None
Coal excise tax (sec. 4121)	• $1.10 per ton from underground mines • $0.55 per ton from surface mines • Capped at 4.4 percent of the price at which such ton of coal is sold by the producer • Dedicated to the Black Lung Disability Trust Fund	Rates are scheduled to decline to 50 cents per ton for underground mines and 25 cents per ton for surface mines (both limited to two percent of the coal's selling price) on the earlier of January 1, 2019 or the first January 1 after which there is no balance of repayable advances that have been made to the Trust Fund and no unpaid interest on previous such advances

2. Transportation, transmission, and generation

Summary of Credit for Electricity Produced from Certain Renewable Resources

Eligible Electricity Production Activity (sec. 45)	Credit Amount for 2013[547] (cents per kilowatt-hour)	Expiration[548]
Wind	2.3	December 31, 2013
Closed-loop biomass	2.3	December 31, 2013
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1.1	December 31, 2013
Geothermal	2.3	December 31, 2013
Small irrigation power	1.1	December 31, 2013
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1.1	December 31, 2013
Qualified hydropower	1.1	December 31, 2013
Marine and hydrokinetic	1.1	December 31, 2013

[547] In general, the credit is available for electricity produced during the first 10 years after a facility has been placed in service. Taxpayers also may elect to receive a 30-percent investment tax credit in lieu of this production tax credit.

[548] Expires for property the construction of which begins after this date.

Summary of Renewable Energy-Related Bond Provisions

Type of Bond	Description
New Clean Renewable Energy Bonds (sec. 54C)	• Tax credit bond • New clean renewable energy bonds ("New CREBs") may be issued to finance "qualified renewable energy facilities." • Credit rate is 70 percent of the rate that permits issuance of bonds without discount and interest cost to the issuer • Qualified issuers include electrical cooperatives, clean renewable energy bond lenders, public power providers, State and local governments (including Indian tribes), and not-for-profit electric utilities which have a loan or loan guarantee under the Rural Electrification Act. • Volume limited ($2.4. billion) all of which has been allocated by the Secretary of the Treasury
Qualified Energy Conservation Tax Credit Bonds (sec. 54D)	• Tax credit bond • Qualified energy conservation ("QEC") bond issuance must be used for "qualified conservation purposes." • Credit rate is 70 percent of the rate that permits issuance of bonds without discount and interest cost to the issuer. • Volume limited ($3.2 billion) and allocated by the Secretary of the Treasury generally in proportion to State population

Summary of Investment Tax Credit Energy Production Incentives

Qualified Energy Property (sec. 48)	Credit rate	Maximum credit	Expiration
Equipment to produce energy from a geothermal deposit	10%	None	None
Equipment to use ground or ground water for heating or cooling	10%	None	December 31, 2016
Microturbine property (< 2 Mw electrical generation power plants of >26% efficiency)	10%	$200 per Kw of capacity	December 31, 2016
Combined heat and power property (simultaneous production of electrical/mechanical power and useful heat > 60% efficiency)	10%	None	December 31, 2016
Solar electric or solar hot water property	30% (10% after December 31, 2016)	None	Rate drops to 10% after December 31, 2016; 10% rate does not expire
Fuel cell property (generates electricity through electrochemical process)	30%	$1,500 for each ½ Kw of capacity	December 31, 2016
Small (<100 Kw capacity) wind electrical generation property	30%	None	December 31, 2016

Summary of Certain Energy Capital Cost Recovery Provisions

Eligible Activity	Description of Provision
Five-year cost recovery for certain energy property (secs. 168(e)(3)(B)(vi))	• A five-year Modified Accelerated Cost Recovery System ("MACRS") recovery period generally is provided for equipment using solar and wind energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat; equipment using solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight; equipment used to produce, distribute, or use energy derived from a geothermal deposit; and qualified fuel cell property. • A five-year MACRS recovery period is provided for certain biomass property, including (i) a boiler, the primary fuel for which will be an alternate substance; (ii) a burner (including necessary on-site equipment to bring the alternate substance to the burner) for a combustor other than a boiler if the primary fuel for such burner will be an alternate substance; (iii) equipment for converting an alternate substance into a qualified fuel; and (iv) certain pollution control equipment.
Alaska natural gas pipeline (secs. 168(e)(3)(C)(iii) and 168(i)(16)(B))	A seven-year MACRS recovery period and a class life of 22 years is provided for any natural gas pipeline system located in the State of Alaska that has a capacity of more than 500 billion Btu of natural gas per day and either is placed in service after December 31, 2013 or the taxpayer elects to treat the system as placed in service on January 1, 2014 (to the extent the system was placed in service before January 1, 2014).
Natural gas gathering lines (sec. 168(e)(3)(C)(iv))	A seven-year MACRS recovery period and 14-year class life is provided for natural gas gathering pipelines placed in service after April 11, 2005.
Pollution control facilities (secs. 169 and 291)	A taxpayer may elect to recover the cost of a certified pollution control facility over a period of 60 months (84 months in the case of certain atmospheric pollution control facilities used in connection with a power plant or other property that is primarily coal-fired). A corporate taxpayer must reduce the amount of basis otherwise eligible for the 60-month recovery by 20 percent.
Nuclear decommissioning costs (sec. 468A)	• Provides a current deduction for contributions to qualified nuclear decommissioning funds. • Lower tax rate on income earned by nuclear decommissioning trusts.

Summary of Energy Credits Related to Fossil Fuel and Nuclear Power Production

Eligible Activity	Description	Credit Amount	Expiration
Advanced coal project credit (sec. 48A)	• Investment credit for projects that use integrated gasification combined cycle ("IGCC") or other advanced coal-based electricity generation technologies • Credits are allocated by the Secretary • First round allocations are capped at $800 million for IGCC projects and $500 million for other projects • Second round allocations are capped at $1.25 billion • Second round projects must generally sequester 65 percent of total CO_2 emissions (70 percent in the case of reallocated credits) • All credits have been fully allocated	• 20 percent for first round IGCC projects • 15 percent for other first round projects • 30 percent for second round projects	None
Advanced nuclear power production credit (sec. 45J)	• Credit for production of nuclear power from new facilities that use modern designs and have received an allocation from the Secretary • Secretary may allocate up 6,000 megawatts of credit-eligible capacity	1.8 cents per kilowatt-hour for the eight-year period starting when the facility is placed in service	Qualified facilities must be placed in service by December 31, 2020
Carbon dioxide sequestration credit (sec. 45Q)	• Credit for the sequestration of industrial source carbon dioxide produced at qualified U.S. facilities • Qualified facilities must capture at least 500,000 metric tons of CO_2 per year. • Must be disposed of in secure geological storage	• $10 for CO_2 used as a tertiary injectant and then permanently sequestered (adjusted for inflation: $10.44 for 2012) • $20 for CO_2 permanently sequestered without being first used as a tertiary injectant (adjusted for inflation: $20.88 for 2012)	End of the year in which the Secretary determines that 75 million tons of CO_2 have been captured and sequestered

Summary of Other Provisions Affecting Energy Distribution and Power Generation

Eligible Activity	Description of Provision	Expiration
Deferral of gains from the sale of electric transmission property (sec. 451(i))	A taxpayer may elect to recognize gain ratably over an eight year period for gains on the disposition of certain electric transmission property.	December 31, 2013
Certain publicly traded partnerships treated as corporations (secs. 7704 and 851)	• The general rule, whereby a publicly traded partnership is taxed as a corporation, is not applicable if 90 percent of gross income is interest, dividends, real property rents, or certain other types of qualifying income. • Energy-related qualifying income includes income and gains derived from fossil fuel or geothermal energy exploration, development, mining, production, refining, transportation (including pipelines), and marketing. • Other types of qualifying income includes income and gains from certain activities with respect to natural resources, including those related to mining, fertilizer, and timber.	None

Summary of Bond Provisions Affecting Energy Generation, Transmission, or Distribution

Type of Bond	Description
Tax-exempt bonds for certain public energy-related projects (sec. 103)	• Tax-exempt bond • May be used for financing government-owned and operated electrical and gas powered generation, transmission, and distribution facilities • Not subject to any volume caps
Tax-exempt bonds for certain private energy-related projects (secs. 141, and 142)	• Tax-exempt bond • May be used for financing certain exempt facilities including privately owned and/or operated utility facilities (local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements), qualified green building, and sustainable design projects • Generally subject to private activity volume cap
Safe harbor from arbitrage rules for prepaid natural gas (sec. 148)	• Allows tax-exempt bonds to be used to finance prepaid natural gas contracts without application of the otherwise applicable arbitrage rules

3. Vehicles, alternative fuels, and specialty manufacturing

Summary of Alternative Fuel Vehicle Credits

Type of Property	Description of Qualifying Property	Credit Amount and Explanation	Expiration
Fuel cell vehicles (sec. 30B)	Vehicles propelled by chemically combining oxygen with hydrogen and creating electricity	• Base credit of $4,000 for vehicles weighing 8,500 pounds or less • Heavier vehicles can get up to a $40,000 credit, depending on weight • An additional $1,000 to $4,000 credit is available to cars and light trucks to the extent fuel economy exceeds 2002 base fuel economy	December 31, 2014
Plug-in electric-drive motor vehicles (sec. 30D)	Four-wheeled vehicles (excluding low speed vehicles and vehicles weighing 14,000 or more) propelled by a battery with at least 4 kilowatt-hours of electricity that can be charged from an external source.	Base credit of $2,500, plus $417 for each kilowatt-hour of additional battery capacity in excess of 4 kilowatt-hours, up to a maximum credit of $7,500	200,000 vehicles per manufacturer limitation
Electric-drive motorcycle and three-wheeled vehicles (sec. 30)	• Vehicles otherwise qualifying as plug-in electric-drive vehicles but for the fact that they have limited speed or less than four wheels • Two- and three-wheeled vehicles must have a battery capacity of at least 2.5 kilowatt-hours	Credit is 10 percent of cost, up to $2,500.	December 31, 2013

Type of Property	Description of Qualifying Property	Credit Amount and Explanation	Expiration
Alternative fuel refueling property (sec. 30C)	Property that dispenses alternative fuels, including ethanol, biodiesel, natural gas, hydrogen, and electricity	30-percent credit up to $30,000 for business property and $1,000 for property installed at a principal residence	• December 31, 2013, for non-hydrogen refueling property • December 31, 2014, for hydrogen refueling property

Summary of Certain Renewable and Alternative Fuel Incentives

Fuel Type	Per Gallon Incentive Amount	Expiration
Agri-biodiesel and biodiesel (secs. 40A, 6426, and 6427)	$1.00 per gallon, plus $0.10 per gallon for small agri-biodiesel producers	December 31, 2013
Renewable diesel (secs. 40A, 6426, and 6427)	$1.00 per gallon	December 31, 2013
Second generation biofuel (cellulosic and algae) (sec. 40)	$1.01 per gallon	December 31, 2013
Special allowance for second generation biofuel (cellulosic and algae) plant property (sec. 168(l))	An additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified cellulosic biofuel plant property	December 31, 2013
Alternative fuel (secs. 6426 and 6427): • **liquefied petroleum gas** • **P Series Fuels** • **compressed or liquefied natural gas** • **liquefied hydrogen** • **any liquid fuel derived from coal through the Fischer-Tropsch process** • **compressed or liquefied gas derived from biomass** • **liquid fuel derived from biomass**	$0.50 per gallon	December 31, 2013 (September 30, 2014, in the case of liquefied hydrogen)

Summary of Specialty Manufacturing Credits

Eligible Activity	Description	Credit Amount	Expiration
Gasification credit (sec. 48B)	• Investment credit for qualified projects that use gasification technology • Qualified projects convert coal, petroleum residue, biomass, or other materials recovered for their energy content into a synthesis gas for direct use or subsequent chemical or physical conversion • Credits are allocated by the Secretary • First round allocations are capped at $350 million • Second round allocations are capped at $250 million • First round projects are generally limited to industrial applications; second round projects include projects designed to produce motor fuels • Second round projects must generally sequester 65 percent of total CO_2 emissions • All credits have been fully allocated	• 20 percent for first round • 30 percent for second round	None
Advanced energy project credit (sec. 48C)	• Investment credit for qualified projects that re-equip, expand, or establish a manufacturing facility for the production of specified energy related products • Credits are allocated by the Secretary and are capped at $2.3 billion • All credits have been fully allocated	30 percent	None

Gas Guzzler Excise Tax

Excise Tax	Description	Expiration
Gas guzzler excise tax (sec. 4064)	Imposed generally on 4-wheeled vehicles weighing 6,000 pounds or less according to the following schedule: • At least 21.5 mpg but less than 22.5 mpg = $1,000 • At least 20.5 mpg but less than 21.5 mpg = $1,300 • At least 19.5 mpg but less than 20.5 mpg = $1,700 • At least 18.5 mpg but less than 19.5 mpg = $2,100 • At least 17.5 mpg but less than 18.5 mpg = $2,600 • At least 16.5 mpg but less than 17.5 mpg = $3,000 • At least 15.5 mpg but less than 16.5 mpg = $3,700 • At least 14.5 mpg but less than 15.5 mpg = $4,500 • At least 13.5 mpg but less than 14.5 mpg = $5,400 • At least 12.5 mpg but less than 13.5 mpg = $6,400 • Less than 12.5 mpg = $7,700	No expiration

Summary of Highway Trust Fund

Excise Tax	Tax Rates[549]	Expiration[550]
Major highway motor fuels excise taxes and credits		
Taxable fuels:		All but 4.3 cents per gallon of the fuel tax rates expires after September 30, 2016
a. Gasoline and gasoline blendstocks (sec. 4081)	18.3 cents per gallon	
b. Diesel fuel and kerosene (secs. 4081 and 4041)	24.3 cents per gallon	
c. Diesel-water fuel emulsion (sec. 4081)[551]	19.7 cents per gallon	
Tax on other motor fuels:		
a. Liquid fuel produced from coal (sec. 4041)	24.3 cents per gallon	
b. Partially exempt ethanol produced from natural gas (sec. 4041(m))	11.3 cents per gallon	Partially exempt ethanol and methanol: After September 30, 2016, the tax rates on these fuels are scheduled to decline to 4.3 cents per gallon (ethanol) and 2.15 cents per gallon (methanol and other non-ethanol alcohol).
c. Partially exempt methanol fuel produced from natural gas (sec. 4041(m))	9.15 cents per gallon	

[549] With the exception of liquefied petroleum gas (propane), compressed natural gas ("CNG"), and liquefied natural gas ("LNG"), highway motor fuels are subject to an additional 0.1 cent-per-gallon tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund.

[550] Although the taxes statutorily expire, for Congressional Budget Office baseline purposes, the taxes are assumed permanent at their current rates.

[551] Diesel-water fuel emulsion consists of a mixture of diesel fuel and at least 14 percent water combined with an emulsion additive that is registered by a U.S. manufacturer with the EPA pursuant to section 211 of the Clean Air Act (as in effect on March 31, 2003) (sec. 4081(a)(2)(D)).

Excise Tax	Tax Rates[549]	Expiration[550]
d. Liquefied natural gas, any liquid fuel (other than ethanol and methanol) derived from coal, and any liquid hydrocarbon derived from biomass (sec. 4041)	24.3 cents per gallon	
e. Liquid motor fuel not described in item d. (sec. 4041)	18.3 cents per gallon	
f. Compressed natural gas ("CNG") (sec. 4041)	18. 3 cents per gasoline gallon equivalent (GGE = 126.67 c.f.)	
Non-fuels taxes imposed on heavy highway vehicles:		
a. Retail sales tax on highway tractors (over 19,500 lbs), heavy trucks (over 33,000 lbs.), and trailers (over 26,000 lbs.) (sec. 4051)	12 percent of retail price	All non-fuels taxes expire after September 30, 2016
b. Manufacturers' excise tax on tires for heavy vehicles (sec. 4071)	9.45 cents for each 10 lbs. in excess of 3,500 lbs. of maximum rated load capacity (4.725 cents for biasply tires and super single tires)	
c. Annual heavy vehicle use tax (sec. 4481)	Under 55,000 lbs. – No tax 55,000-75,000 lbs. − $100 plus $22 per 1,000 lbs. over 55,000 lbs. Over 75,000 lbs. − $550	

Summary of Airport and Airways Trust Fund Excise Taxes

Tax (and Code section)	Tax Rates	Expiration[552]
a. Domestic air passengers (sec. 4261)	7.5 percent of fare, plus $3.90 (2013) per domestic flight segment generally[553]	Non-fuel taxes: expire after September 30, 2015. Fuel taxes: All but 4.3 cents per gallon of the fuel tax rates expire after September 30, 2015. Surtax on fuel used in fractional ownership aircraft expires September 30, 2021.
b. International air passengers (sec. 4261)	$17.20 (2013) per arrival or departure[554]	
c. Amounts paid for right to award free or reduced rate passenger air transportation (sec. 4261)	7.5 percent of amount paid	
d. Air cargo (freight) transportation (sec. 4271)	6.25 percent of amount charged for domestic transportation; no tax on international cargo transportation	
e. Aviation fuels (sec. 4081):[555]		
i. Commercial aviation	4.3 cents per gallon	
ii. Non-commercial (general) aviation:	19.3 cents per gallon	
Aviation gasoline Jet fuel	21.8 cents per gallon	

[552] Although the taxes statutorily expire, for Congressional Budget Office baseline purposes, the taxes are assumed permanent at their current rates.

[553] The domestic flight segment portion of the tax is adjusted annually (effective each January 1) for inflation (adjustments based on the changes in the consumer price index (the "CPI")).

[554] The international arrival and departure tax rate is adjusted annually for inflation (measured by changes in the CPI). In the case of a flight beginning or ending in Alaska or Hawaii, there is a departure tax of $8.60 for 2013. Rev. Proc. 2012-41.

[555] Like most other taxable motor fuels, aviation fuels are subject to an additional 0.1-cent-per-gallon excise tax to fund the LUST Trust Fund.

Tax (and Code section)	Tax Rates	Expiration[552]
f. Surtax on fuel used in aircraft in a fractional ownership program (sec. 4043)	14.1 cents per gallon	

Summary of Financing Rates for the Leaking Underground Storage Tank Trust Fund, Oil Spill Liability Trust Fund and Inland Waterways Trust Fund

Tax (and Code section)	Tax Rates	Expiration[556]
Leaking Underground Storage Tank Trust Fund financing rate (sec. 4081(d)(3)	Generally an additional 0.1 cent per gallon on highway and aviation fuels	Tax does not apply after September 30, 2016
Oil Spill Liability Trust Fund financing rate (sec. 4611)	8 cents a barrel (9 cents during calendar year 2017)	Tax does not apply after December 31, 2017
Inland Waterways Trust Fund Financing rate (sec. 4042)	20 cents per gallon on diesel fuel and other liquid fuels used by commercial cargo vessels on specified inland and intra-coastal waterways	None

[556] Although the taxes statutorily expire, for Congressional Budget Office baseline purposes, the taxes are assumed permanent at their current rates.

4. Conservation and consumption

Summary of Energy Conservation Credits

		Credit rate or amount	Maximum credit	Expiration
Personal credits:				
Nonbusiness energy property credits (sec. 25C)	Insulation to international energy conservation code standard and energy efficient windows, doors, skylights, roofs.	10 %	$500 (overall 25C credit maximum) ($200 for windows and skylights)	December 31, 2013
	Advanced main air circulating fans	100%	$50	December 31, 2013
	Qualified natural gas, propane, or oil furnace or hot water boilers	100%	$150	December 31, 2013
	Qualified electric heat pump water heaters or natural gas, propane, or oil water heaters	100%	$300	December 31, 2013
	Qualified central air conditioners	100%	$300	December 31, 2013
	Qualified biomass fuel property (wood stoves)	100%	$300	December 31, 2013
Residential energy efficient property credits (sec. 25D)	Residential solar water heating or solar electric property	30 %	None	December 31, 2016
	Residential small wind property	30 %	None	December 31, 2016
	Residential geothermal heat pump property	30 %	None	December 31, 2016
	Residential fuel cell property	30 %	$500 per half kilowatt of capacity	December 31, 2016
Business Credits:				
Manufacturer credit for new energy efficient home (sec. 45L)	Homes 30% more efficient than standard	$1,000 per home	None	December 31, 2013
	Homes 50% more efficient than standard	$2,000 per home	None	December 31, 2013
Manufacturer credit for energy efficient appliances (sec. 45M)	Dishwashers	$50	(1)	December 31, 2013
	Dishwashers (higher efficiency standard)	$75	(1)	December 31, 2013
	Clothes washers	$225	None	December 31, 2013
	Refrigerators	$150	(1)	December 31, 2013
	Refrigerators (higher efficiency standard)	$200	None	December 31, 2013

(1) A given manufacturer may not claim credits in excess of an aggregate of $25 million for taxable years beginning after December 1, 2010, with respect to all credits excepting the $200 credit for refrigerators and the $225 credit for clothes washers.

Summary of Other Provisions Affecting Energy Consumption

Eligible Activity	Description	Credit Amount	Expiration
Energy conservation subsidies provided by public utilities (sec. 136)	Energy conservation subsidies provided by public utilities are excluded from gross income	N/A	None
Energy efficient commercial buildings deduction (sec. 179D)	A taxpayer may take an additional deduction of $1.80 per square foot of commercial building property that exceeds certain energy efficiency standards. Taxpayer may alternatively take a $0.60 per square foot deduction for each building subsystem that qualifies: (1) lighting, (2) building envelope, and (3) heating ventilation and air conditioning	N/A	December 31, 2013

5. Competitiveness

Summary of Rules Affecting Domestic and International Competitiveness of Energy Companies

Status or Activity	Description of Provision
Dual Capacity Taxpayers (sec. 901)	• In general, a taxpayer receives a credit against U.S. taxes for income taxes paid to a foreign country related to economic activity in that country. Royalties paid to a foreign country for extracting oil and gas from that country are not creditable against U.S. taxes. • A dual capacity taxpayer is a taxpayer that is subject to a foreign levy and also receives a specific economic benefit from the foreign country (*e.g.*, pays a tax to an oil exporting country and receives a license to extract oil and gas from that country) • Dual capacity taxpayers can use either a safe harbor or facts and circumstances method to establish that a foreign levy is a creditable tax and not a royalty-like payment for a specific economic benefit from the foreign country. • The taxpayer need not establish that the foreign country generally imposes an income tax to establish a levy is a creditable tax.
Domestic Production Activities (sec. 199)	• Taxpayers generally are permitted a nine percent deduction for domestic production activities. • The deduction is reduced to six percent for qualified production activities income attributable to the production refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. • The deduction cannot exceed the lesser of taxable income or 50 percent of qualifying wages.

6. Other energy tax provisions

Summary of Other Energy Credits

Eligible Activity	Description	Credit Amount	Expiration
Energy research credit (sec. 41)	• Credit for payments made to energy research consortia for qualified energy research • Includes research related to fossil fuels as well as to renewable energy technologies	20 percent of total qualified expenses (non-incremental)	December 31, 2013

E. Present Law: Financial Services Businesses and Financial Instruments

1. Banks, thrifts, and credit unions

Corporations generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[557] generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Corporations that make a valid election pursuant to section 1362 of subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items upon a subsequent disposition of S corporation stock, each shareholder's basis in such stock is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

To qualify for S corporation status, a corporation must be a small business corporation as defined in section 1361(b)(1) and not be an ineligible corporation as defined in section 1361(b)(2). A corporation qualifies as a small business corporation if it has 100 or fewer shareholders, has only individuals or certain trusts and estates as shareholders, has no nonresident aliens as shareholders, and has only one class of stock. Ineligible corporations include any financial institution using the reserve method of accounting for bad debts (discussed below) and any insurance company subject to subchapter L of the Code.

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 certain specified exceptions. There is no sector-

[557] 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.

specific Federal income tax currently applied to financial institutions, and there are currently no corporate taxes assessed on the balance sheet liabilities of an entity.

Certain special rules and exceptions that are applicable to determining the Federal income tax liability of banks and thrifts, certain other financial institutions, insurance companies, and broker dealers are discussed below.

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.[558] 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.[559] Prior to 1951, thrifts were exempt from Federal taxation. In 1951, mutual savings banks and savings and loan associations lost their tax exemption because they were viewed as being "in active competition with commercial banks and life insurance companies for the public savings."[560]

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.[561]

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. For taxable years beginning before 1987, section 166(c) allowed taxpayers to deduct annual reasonable additions to a reserve established for bad debts (in lieu of deducting specific debts as worthless in the year in which the bank determined the debt was worthless). The reserve method of accounting for bad debts was repealed in 1986[562] for most taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu

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[558] Sec. 581.

[559] See Treas. Reg. sec. 1.581-1 ("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank…there are certain exceptions and special rules [for such institutions]").

[560] S. Rep. No. 82-781, Revenue Act of 1951, p. 25.

[561] Sec. 1361(b)(2).

[562] Tax Reform Act of 1986, Pub. L. No. 99-514.

of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

Prior to 1996, thrifts (mutual savings banks, domestic savings and loan associations, and cooperative banks) had separate bad debt reserve rules under section 593. The special rules for thrifts were repealed for tax years beginning on or after January 1, 1996.[563]

Credit unions

Credit unions are exempt from Federal income taxation.[564] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater utilization of credit unions.[565] 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.[566]

Gains and losses with respect to securities held by financial institutions

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain of a corporation is currently taxed at a rate not to exceed 35 percent, which is also the maximum corporate income tax rate. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are

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[563] The Small Business and Job Protection Act of 1996, Pub. L. No. 104-188.

[564] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070.htm.

[565] 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.

[566] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070.htm.

allowed only to the extent of gains from such sales or exchanges. Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income. However, in general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year.

In the case of an S corporation, net capital losses flow through to the corporation's shareholders and could be considered losses attributable to a banking business in such shareholders' hands. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the assets, liabilities, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year attributable to that banking business. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

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

Under section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. Thus, generally, as a manufacturer receives ordinary income treatment on sale of its inventory, so does a financial institution on the sale or exchange of its loans under section 582. A financial institution described in section 582(c)(2) includes: (1) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation); (2) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law; (3) any small business investment company operating under the Small Business Investment Act of 1958; and (4) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of

promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Stock (including preferred stock) is not considered indebtedness for tax purposes and therefore is not treated as an asset entitled to ordinary gain or loss treatment under section 582.[567] However, under section 301 of Division A of the Emergency Economic Stabilization Act of 2008, gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company, as defined in the Federal Deposit Insurance Act.[568] Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (1) held by the applicable financial institution on September 6, 2008, or (2) sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[569]

2. Insurance companies

Taxable insurance companies in general

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. An insurance company is defined in the life insurance rules as a company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Generally, an insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[570] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

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[567] Under section 306 of the Code, the sale of certain preferred stock can produce ordinary income to any taxpayer (without regard to section 582).

[568] 12 U.S.C. sec. 1813(w)(1).

[569] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9 percent of the common stock of such companies.

[570] Sec. 816.

Life insurance companies[571]

A life insurance company, whether stock or mutual, is taxed at regular corporate rates on its life insurance company taxable income ("LICTI"). LICTI is life insurance gross income reduced by life insurance deductions.[572] An alternative tax applies if a company has a net capital gain for the taxable year, if such tax is less than the tax that would otherwise apply. Life insurance gross income is the sum of (1) premiums, (2) decreases in reserves, and (3) other amounts generally includible by a taxpayer in gross income. Methods for determining reserves for Federal income tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Because deductible reserves might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by a portion of tax-exempt interest (known as a proration rule).[573] Similarly, 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.[574]

Life insurance companies (subject to tax under section 801) generally may not be included in a consolidated return of an affiliated group including nonlife-insurance companies, unless the common parent of the group elects to treat the life insurance companies as includible corporations.[575] Under the election to treat life insurance companies as includible corporations of an affiliated group, two special 5-year limitation rules apply. The first 5-year rule provides that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed.[576] The second 5-year rule provides that any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first 5 years the life and nonlife-insurance corporations have been members of the same affiliated group.[577] This rule applies to nonlife losses for the current

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[571] A discussion of the tax treatment of life insurance and annuity contracts is provided in Present Law relating to Pensions/Retirement.

[572] Sec. 801.

[573] Secs. 807(b)(2)(B) and (b)(1)(B).

[574] Secs. 805(a)(4), 812. Fully deductible dividends from affiliates are excluded from the application of this proration formula (so long as such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer). In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts owned by the company (the inside buildup on which is not taxed).

[575] Sec. 1504(c)(2).

[576] Sec. 1504(c)(2).

[577] Sec. 1503(c)(2).

taxable year or as a carryover or carryback. A separate 35-percent limitation also applies under the election to treat life insurance companies as includible corporations of an affiliated group.[578] This rule provides that if the non-life-insurance members of the group have a net operating loss, then the amount of the loss that is not absorbed by carrybacks against the nonlife-insurance members' income may offset the life insurance members' income only to the extent of the lesser of: (1) 35 percent of the amount of the loss; or (2) 35 percent of the life insurance members' taxable income. The unused portion of the loss is available as a carryover and is added to subsequent-year losses, subject to the same 35-percent limitation.

Property and casualty insurance companies

The taxable income of a property and casualty insurance company, whether stock or mutual, is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[579] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.[580]

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.[581] Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). Present law limits the deduction for unpaid losses to the amount of discounted unpaid losses, which are discounted using prescribed discount periods and a prescribed interest rate, to take account partially of the time value of money.[582] Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

In calculating its reserve for losses incurred, a proration rule requires that a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns (sec. 832(b)(5)). This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

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[578] Sec. 1503(c)(1).

[579] Sec. 832.

[580] Sec. 832(b)(1)(A).

[581] Sec. 832(b)(3). In determining premiums earned, the company deducts from gross premiums the increase in unearned premiums for the year (sec. 832(b)(4)(B)). The company is required to reduce the deduction for increases in unearned premiums by 20 percent, reflecting the matching of deferred expenses to deferred income.

[582] Sec. 846.

Certain tax rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[583]

Reinsurance

Reinsurance is a transaction between insurers that shifts a risk, or group of risks, from one insurer to another. For life insurance companies, a deduction is permitted for consideration − including reinsurance premiums − paid in respect of assumption of liabilities under insurance and annuity contracts.[584] Similarly, in determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance.[585] A rule enacted in 1984 provides authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion.[586]

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[587] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[588] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are

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[583] Secs. 841-848.

[584] Sec. 805(a)(6).

[585] Sec. 832(b)(4)(A).

[586] Sec. 845. See Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

[587] Secs. 4371-4374.

[588] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[589]

Tax-exempt insurance organizations described in section 501(c)

Section 501(a) generally provides for exemption from Federal income tax for certain organizations.[590] Although most organizations that engage principally in insurance activities are not exempt from Federal income tax, certain organizations that engage in insurance activities are described in section 501(c) and exempt from tax under section 501(a). Section 501(c)(8), for example, describes certain fraternal beneficiary societies, orders, or associations operating under the lodge system or for the exclusive benefit of their members that provide for the payment of life, sick, accident, or other benefits to the members or their dependents. Section 501(c)(9) describes certain voluntary employees' beneficiary associations that provide for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries. Section 501(c)(12)(A) describes certain benevolent life insurance associations of a purely local character. Section 501(c)(15) describes certain small non-life insurance companies with annual gross receipts of no more than $600,000 ($150,000 in the case of a mutual insurance company). Section 501(c)(26) describes certain membership organizations established to provide health insurance to certain high-risk individuals.[591] Section 501(c)(27) describes certain organizations established to provide workmen's compensation insurance. Section 501(c)(29) describes qualified nonprofit health insurance issuers. In judicial decisions,

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[589] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the Revenue Ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the Revenue Ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[590] Under the unrelated business income tax (UBIT) rules of sections 511-515, generally, income derived from a trade or business regularly carried on by a tax-exempt organization that is not substantially related to the performance of the organization's tax-exempt functions is subject to UBIT. Certain types of income are specifically exempt from UBIT, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.

[591] When section 501(c)(26) was enacted in 1996, the House Ways and Means Committee, in reporting out the bill, stated as its reasons for change: "The Committee believes that eliminating the uncertainty concerning the eligibility of certain State health insurance risk pools for tax-exempt status will assist States in providing medical care coverage for their uninsured high-risk residents." H.R. Rep. No. 104-496, Part I, "Health Coverage Availability and Affordability Act of 1996," 104th Cong., 2d Sess., March 25, 1996, 124. See also Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996, p. 351.

certain health maintenance organizations (HMOs) have been held to qualify for tax exemption as charitable organizations described in section 501(c)(3).[592]

Certain organizations providing commercial-type insurance

Section 501(m) provides that an organization may not be exempt from tax under section 501(c)(3) (generally, charitable organizations) or section 501(c)(4) (social welfare organizations) unless no substantial part of its activities consists of providing commercial-type insurance. For this purpose, commercial-type insurance excludes, among other things: (1) insurance provided at substantially below cost to a class of charitable recipients; and (2) incidental health insurance provided by an HMO of a kind customarily provided by such organizations.

Section 833 treatment for certain taxable health insurance providers

When section 501(m) was added in 1986, special rules were provided under section 833 for taxable Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year. Any other organization is eligible for section 833 treatment if it meets six requirements set forth in section 833(c): (1) substantially all of its activities involve providing health insurance; (2) at least 10 percent of its health insurance is provided to individuals and small groups (not taking into account Medicare supplemental coverage); (3) it provides continuous full-year open enrollment for individuals and small groups; (4) for individuals, it provides full coverage of pre-existing conditions of high-risk individuals and coverage without regard to age, income, or employment of individuals under age 65; (5) at least 35 percent of its premiums are community rated; and (6) no part of its net earnings inures to the benefit of any private shareholder or individual.

Section 833 provides a deduction with respect to health business of such organizations. The deduction is equal to 25 percent of the sum of (1) claims incurred, and liabilities incurred under cost-plus contracts, for the taxable year, and (2) expenses incurred in connection with administration, adjustment, or settlement of claims or in connection with administration of cost-plus contracts during the taxable year, to the extent this sum exceeds the adjusted surplus at the beginning of the taxable year. Only health-related items are taken into account.

Section 833 provides an exception for such an organization from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty companies.

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[592] See *Sound Health Association v. Commissioner,* 71 T.C. 158 (1978), *acq.* 1981-2 C.B. 2; but see *Geisinger Health Plan v. Commissioner,* 985 F.2d 1210 (3rd Cir. 1993), rev'g T.C. Memo. 1991-649, and *IHC Health Plans, Inc. v. Commissioner,* 325 F.3d 1188 (10th Cir. 2003).

Section 833 provides that such an organization is taxable as a stock property and casualty insurer under the Federal income tax rules applicable to property and casualty insurers.

3. Broker-dealers

For Federal income tax purposes, a person generally is a securities dealer if such person regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[593] The determination of dealer status is made based on all facts and circumstances. The courts and the IRS have considered the following factors in evaluating dealer status: (1) being licensed as a dealer;[594] (2) holding oneself out to the public as a dealer;[595] (3) selling inventoried securities to customers;[596] (4) the frequency, extent, and regularity of securities transactions;[597] (5) profiting from commissions as opposed to appreciation in the value of securities;[598] and (6) ownership of a securities exchange membership.[599]

Securities dealers must account for their securities inventory using the mark-to-market accounting method.[600] In general, under that method, securities held by a dealer in its inventory are marked to fair market value at the close of the taxable year, with any resulting difference between value and basis included as ordinary income or loss in computing taxable income for such year. For this purpose a security is defined as any share of stock in a corporation, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, interest rate, currency, or equity notional principal contract, and evidence of an interest in, or a derivative financial instrument in any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.[601] Additionally, a security includes a position that is not one of the foregoing, but is a hedge with respect to such security,

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[593] Sec. 475(c)(1) (defining a securities dealer for purposes of section 475); cf. Treas. Reg. sec. 1.864-2(c)(2)(iv) (defining a dealer in stock or securities for purposes of the trader safe harbors to section 864) and Treas. Reg. sec. 1.471-5 (as amended in 1993).

[594] *Polachek v. Commissioner,* 22 T.C. 858, 859 (1954).

[595] *Verito v. Commissioner,* 43 T.C. 429, 441-442 (1965), acq. 1965-2 C.B. 7.

[596] *United States v. Chinook Investment Co.,* 136 F.2d 984 (9th Cir. 1943).

[597] *Purvis v. Commissioner,* 530 F.2d 1332, 1334 (9th Cir. 1976).

[598] *Kemon v. Commissioner*, 16 T.C. 1026, 1033 (1951).

[599] *Securities Allied Corp. v. Commissioner*, 95 F.2d 284, 286 (2d Cir. 1938), aff'g 36 B.T.A 168 (1937), cert denied, 305 U.S. 617 (1938).

[600] Sec. 475.

[601] Sec. 475(c)(2). The definition of securities under section 475 excludes sec. 1256 contracts, which include futures contracts and certain exchange-traded options.

and is clearly identified in the dealer's records as a security before the close of the day on which it was acquired.[602]

Special rules apply to gains and losses of a securities dealer with respect to "section 1256 contracts."[603] Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.[604] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[605]

A securities dealer may also hold securities for investment rather than as inventory (such securities are not subject to mark-to-market accounting, and any gains or losses with respect thereto treated as capital rather than ordinary).[606] Additionally, a dealer is not subject to mark-to-market accounting for debt securities originated or entered into in the ordinary course of its trade or business that are not held for sale.[607] For either of these exceptions to apply, the dealer must clearly identify that the security is either held for investment or not held for sale by the close of the day the security is acquired and the security may not at any time thereafter be held primarily for sale to customers.[608]

4. Regulated investment companies or RICs (mutual funds)

In general, a RIC is an electing domestic corporation that either meets (or is excepted from) certain registration requirements under the Investment Company Act of 1940,[609] that derives at least 90 percent of its ordinary income from specified sources considered passive

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[602] Sec. 475(c)(2)(F).

[603] Section 1256(b) provides that a "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract; (3) nonequity option, (4) dealer equity option; and (5) dealer securities futures contract, but does not include any securities future contract or option on such contract unless such contract or option is a dealer securities future 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.

[604] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

[605] Sec. 1256(c)(1). Additionally, section 1212(c) provides that a taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.

[606] Secs. 1236 and 475(b)(1).

[607] Sec. 475(b)(1).

[608] Secs. 1236(a) and (d)(1). See also section 475(b)(2).

[609] Secs. 851(a) and (b)(1).

investment income,[610] that has a portfolio of investments that meet certain diversification requirements,[611] and meets certain other requirements.[612]

Many RICs are "open-end" companies (mutual funds) which have a continuously changing number of shares that are bought from, and redeemed by, the company and that are not otherwise available for purchase or sale in the secondary market. Shareholders of open-end RICs generally have the right to have the company redeem shares at "net asset value." Other RICs are "closed-end" companies, which have a fixed number of shares that are normally traded on national securities exchanges or in the over-the-counter market and are not redeemable upon the demand of the shareholder.

In the case of a RIC that distributes at least 90 percent of its net ordinary income and net tax-exempt interest to its shareholders, a deduction for dividends paid is allowed to the RIC in computing its tax.[613] Thus, no corporate income tax is imposed on income distributed to its shareholders. Dividends of a RIC generally are includible in the income of the shareholders; a RIC can pass through the character of (1) its long-term capital gain income, by paying "capital gain dividends" and (2) in certain cases, tax-exempt interest, by paying "exempt-interest dividends." A RIC may also pass through certain foreign tax credits and credits on tax-credit bonds, as well as the character of certain other income received by the RIC.

5. U.S. income tax principles applicable to the taxation of financial instruments

In general

Fundamental to the Federal income tax system is the determination of income subject to tax. This section outlines the basic principles of timing, character, and source. These three principles are central to the application of the income tax. A variety of factors affect their application.

A threshold issue for application of the income tax is determining to whom the tax should apply. Although it is generally the owner of the income who is subject to the tax, the Code does not provide a definition of ownership. In the absence of specific rules, courts have detailed factors relevant to determining the owner of income for Federal tax purposes. In the context of financial instruments these factors include who (1) bears the risk of loss and has the opportunity for gain; (2) has the right to receive current income or distributions; (3) may exercise any rights attending the instrument such as voting or enforcement rights; and (4) has the right to dispose of the property. Considerations of ownership may be complicated by the ability of taxpayers to

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[610] Sec. 851(b)(2).

[611] Sec. 851(b)(3).

[612] Secs. 851 and 852.

[613] Sec. 852(a) and (b).

structure financial arrangements that deliver some (or all) of the economics of ownership but none (or some) of the other attributes of ownership.

The manner of a taxpayer's participation in the market also may affect the timing, character, and source of income. For example, the Code taxes investors, traders, and dealers in securities and commodities and related financial instruments differently. A taxpayer's status in this regard is generally determined by both the nature and the extent of his activities. Generally, an investor is a taxpayer who seeks to profit solely from changes in the price of, and income earned on, financial products he holds, and is not engaged in a trade or business.[614] In contrast, a trader is someone in a trade or business of buying and selling assets in an effort to catch swings in the daily market and profit thereby on a short-term basis.[615] A person is a dealer in securities, for example, if such person regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[616] A taxpayer may qualify for more than one status at any given time with respect to different instruments.

Some parties to a transaction may be indifferent to the timing, character, and source of income because they are either exempt from tax or are required to mark positions to market as ordinary income in any event (*e.g.*, section 475 securities dealers) or for other reasons. In such cases taxable parties may enter into transactions with the tax indifferent party to achieve a desired tax result.

In addition to considerations of the taxpayer's status, other activities of the taxpayer may come into play. For example, specialized rules for tax hedges, transactions entered into in the normal course of a taxpayer's trade or business primarily to manage certain risks with respect to ordinary property or obligations, can change the timing, character, and source of income.[617] As another example, financial products issued by life insurance companies, such as life insurance contracts and annuity contracts, are subject to different rules that are not described in this document.

Following is a description of some of the most relevant rules for determining timing, character, and source of income in the context of financial instruments.

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[614] *Whipple v. Commissioner*, 373 U.S. 193 (1963).

[615] See, *e.g.*, *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1995).

[616] See sec. 475(c)(1) (defining a securities dealer for purposes of section 475); *Bielfeldt v. Commissioner*, 231 F.3d 1035 (7th Cir. 2000) (describing the difference between a trader and a dealer and noting that "the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely fluctuations in the market value of the securities or other assets that he transacts in.").

[617] Sec. 1221(b)(2).

Timing of income rules

A fundamental principle of income tax is the determination of when an item of income (or expense) is required to be taken into account for income tax purposes.[618] Because of the time value of money, whereby the present value of a future tax liability is less than the value of the same tax liability in the current year and holding other factors such as tax rates constant, most taxpayers prefer to delay taking income into account. The tax rules do not, however, permit a taxpayer to choose the timing of income simply to minimize that taxpayer's tax burden. Instead, as a general matter, a taxpayer must compute taxable income under a method of accounting that "clearly reflect[s] income."[619] Within this broad requirement that a taxpayer's accounting method produce a clear reflection of the taxpayer's income, the timing rules vary based on the taxpayer's method of accounting as well as the particular item of income.

In general, for a cash basis taxpayer (*e.g.*, an individual), an amount is included in income when received.[620] For an accrual basis taxpayer (*e.g.*, a corporation), an amount generally is recognized (and included in income) the earlier of when such amount is earned by, due to, or received by the taxpayer, unless an exception permits deferral or exclusion.[621]

Regardless of a taxpayer's method of accounting (cash or accrual), some forms of income are taxed as they accrue, while the taxation of other forms of income are delayed until a later date. For example, an employee generally is taxed on wages and other compensation for services when the employee receives the wages or other compensation.[622] In contrast, an employee generally is not taxed on amounts under certain employee benefit plans until the employee withdraws the amounts.[623] However, when dealing in financial instruments, it is not always clear when the amounts exchanged, pledged, or promised upon execution of a contract should be included in the taxpayer's income (*e.g.*, upon physical receipt of the payment, when another step of the transaction occurs, or upon completion of the entire contract). One way of understanding the general approach to the timing of taxation of financial instruments is that

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[618] For purposes of brevity, this discussion addresses only the timing of income inclusion (including gains and losses from the sale, exchange or disposition of a financial instrument), not the timing of an expense allowance. Expenses, though, present similar issues of timing. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 258-269, for a detailed discussion of when an expense may be taken into account.

[619] Sec. 446(b).

[620] Sec. 451(a).

[621] Sec. 451. For examples of deferral opportunities, see sections 453 or 455, Treas. Reg. section 1.451-5, or Rev. Proc. 2004-34, 2004-1 C.B. 991.

[622] See also section 83 which provides special rules for property, including stock and options, transferred in connection with the performance of services.

[623] For example, amounts withdrawn from pension accounts during retirement (and included in income when withdrawn) often relate to services that the employee performed at an earlier time. See, *e.g.*, sections 401, 402, 403.

income from instruments with fixed returns (such as bonds) is taxed annually, while income from instruments with contingent returns (such as stock) is taxed on a wait-and-see (open transaction) basis.[624]

Income is recognized for most financial instruments on a wait-and-see basis whereby the execution of the contract has no immediate income tax consequences. Instead, the taxpayer includes amounts in income when they are "realized." For example, although a taxpayer has income in an economic sense when the price of a share of stock that the taxpayer owns increases, the taxpayer does not have taxable income from that price appreciation until there is a realization event in respect of the stock – that is, until the taxpayer sells the stock.[625] As is described in more detail below, income from an option or a forward or futures contract is also generally taxed on a realization basis. As with stock, the returns on these derivative financial instruments are contingent. However, if the option or forward or futures contract is subject to section 1256 (discussed below), the income may be included at an earlier time.

As with most areas of the Federal tax code, there are exceptions to the general realization rules. One such exception relates to interest from a bond. For example, just as an individual is taxed on interest income that the individual receives from holding a bond (an instrument that provides fixed returns), taxpayers are taxed under the original issue discount ("OID") rules on interest that is deemed to accrue each year on a bond that pays no interest (a zero-coupon bond) until the maturity date.[626]

Another such exception requires gains or losses from financial instruments to be recognized in advance of when the contract would otherwise dictate (*i.e.*, when the amounts are realized). Mark-to-market is the most common tax accounting method requiring early recognition.[627] This departure from the normal realization-based tax accounting principles requires certain types of taxpayers (*e.g.*, dealers) with certain types of contracts (*e.g.*, regulated futures contracts or foreign currency contracts) to recognize the gain or loss with respect to those unsettled financial contracts as if the transactions were completed on the last day of the tax year, if not more frequently.

Similarly, in certain instances, amounts are required to be included in income upon execution of the contract. For example, shares of stock traded in an OTC market or on an exchange are considered purchased or sold on the date that the taxpayer enters into a binding contract to buy or sell the stock ("trade date") even if the stock is transferred on another date

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[624] See Alvin C. Warren, Jr., "Financial Contract Innovation and Income Tax Policy," *Harvard Law Review,* vol. 107, p. 465. Warren argues that the different taxation of fixed returns and contingent returns is unworkable when financial instruments offer both kinds of returns. For a discussion of this difficulty, see section III.B. below.

[625] For the rule codifying the realization principle, see section 1001.

[626] See also sections 1271-1275.

[627] See secs. 475 and 1256. These mark-to-market rules supersede the fixed-versus-contingent return distinction.

("settlement date"). Accordingly, revenue is recognized and amounts are included in the taxpayer's income on the trade date.[628] Conversely, there are other instances where gains or losses from financial instruments are allowed to be deferred even though the underlying contract is complete.[629] More detailed discussions of the effect of timing on financial instruments are included in sections III and IV below.

Character of income rules

In general

The characterization of income, gain, or loss as ordinary or capital is another significant income tax principle in calculating income tax liability. While a dollar of income is just that, a dollar, whether it is from, for example, the performance of services (*e.g.*, wages), the trading of a financial instrument (*e.g.*, stock), or the sale of an asset (*e.g.*, depreciable property) affects the rate at which the income is taxed and the amount of losses that may be taken as a current deduction. The tax rules distinguish between ordinary and capital income. Thus, the characterization of the gains or losses derived from the sale, exchange, or disposition of a financial instrument can affect the amount of a taxpayer's tax liability.[630]

In general, gains considered ordinary in nature are taxed at the taxpayer's marginal tax rate for the year such amounts are included in income. Conversely, the amount of ordinary losses in excess of ordinary gains that can be taken into account by a taxpayer in any given year may be limited due to a taxpayer's filing status (*e.g.*, individual or corporation).[631] Capital gains, on the other hand, may be taxed at a lower rate for certain taxpayers.[632] Similar to ordinary losses, the deduction for capital losses in excess of capital gains may be limited in any given

[628] For both cash and accrual taxpayers, section 453(k) provides that the recognition of gain or loss on an exchange takes place on the trade date. See also Rev. Rul. 93-84, 1993-2 C.B. 225.

[629] See, *e.g.*, secs. 1043 (conflict of interest) and 1044 (qualified small businesses).

[630] The computation of taxpayer's gain or loss from the sale of a financial instrument is not discussed in detail. As with most other sales of property, section 1001 provides that gain or loss from the sale of most financial instruments is measured by the difference between the seller's basis and the amount of money plus the fair market value of property (if any) received. The seller's basis usually consists of the amount paid for the stock (adjusted to take into account any distributions of capital, stock dividends, etc.) plus capitalized costs of acquisition (primarily brokers' commissions).

[631] See, for example, section 469 regarding passive activity loss limitations for an individual. But, also see section 165 for treatment losses of a corporation.

[632] See section 1(h) for capital gains tax rates for individuals.

year.[633] While a dollar of income is a dollar of income regardless of the origin, there is a distinction between capital and ordinary income for tax purposes.[634]

Capital gain treatment

Capital gains and losses result when a capital asset is sold, exchanged, or disposed. In general, a capital asset is defined as property held by a taxpayer other than: (1) inventory; (2) property subject to the allowance for depreciation, including real property;[635] (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by the taxpayer;[636] (4) accounts or notes receivables acquired in the ordinary course of business (*e.g.*, for providing services or selling property); (5) a publication of the U.S. government other than that which is held for sale by the U.S. government; (6) any commodities derivative financial instrument held by a commodities dealer unless clearly identified as a capital asset; (7) any hedging transaction clearly identified as such; or (8) supplies of a type regularly consumed in the taxpayer's ordinary course of business.[637] Further, gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to a capital asset would be characterized as capital in nature.[638]

Short-term versus long-term

Once it is determined that gain or loss from the sale of property is capital gain or loss, it is necessary to determine whether such gain or loss is short- or long-term determined in reference to the holding period.[639] In general, short-term capital gains and losses are those related to the sale, exchange, or disposition of a capital asset held by the taxpayer for not more than one year.[640] Conversely, long-term capital gains and losses are those derived from the sale,

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[633] See section 1211 for capital loss limitations.

[634] This distinction between capital and ordinary income might be justified in promoting certain nontax policy goals, such as saving or investment.

[635] However, section 1231 provides that to the extent gains from the sale, exchange, or involuntary conversion of property used in the taxpayer's trade or business exceeds losses from similar property, such gains and losses shall be treated as long-term capital gains and long-term capital losses. Section 1231 specifically excludes inventory and property held primarily for sale in the ordinary course from the definition of property used in the taxpayer's trade or business for purposes of this section.

[636] This includes a letter, memorandum, or similar property held by a taxpayer for whom such property was prepared or produced.

[637] Sec. 1221(a).

[638] Sec. 1234A. Specifically excluded from the above definition of right or obligation are securities futures contracts defined in 1234B. Further, section 1256 contracts are excluded from the capital treatment afforded in section 1234A.

[639] Sec. 1223(a) and Treas. Reg. sec. 1.1223-1(a). See also section 1234A.

[640] Sec. 1222(1) and (2).

exchange, or disposition of a capital asset held by the taxpayer for more than one year.[641] However, there are exceptions to the general rules regarding classification of capital gains and losses as short or long-term.[642]

The classification of gains and losses as short- or long-term may result in more favorable tax treatment since short and long-term gains must be netted with their respective short- or long-term losses for any given tax year.[643] Further, the tax rates for capital gains may be lower than the tax rates on ordinary income. For example, the tax rate for long-term capital gains derived from the sale by an individual of a financial instrument could be 10 to 20 percentage points less than a taxpayer's individual tax rate on ordinary income.[644]

Capital loss limitation

To the extent capital losses exceed capital gains in any given tax year, a taxpayer's entity choice may result in limiting the amount of losses that can be claimed by the taxpayer. In general, corporations may only claim capital losses to the extent of such gains.[645] All other taxpayers may claim capital losses up to $3,000 in excess of capital gains for such taxable year.[646]

Ordinary income

Amounts not otherwise determined to be capital in nature are generally included as ordinary income and taxed at the applicable rates. This includes amounts earned by dealers, interest, dividends, as well as amounts earned from property held by a taxpayer that is specifically excluded from the definition of a capital asset. While dividends are considered ordinary income, qualifying dividends are taxed at capital gains rates for the 2003-2012 tax years.[647] Further, as with the rules regarding capital treatment, there are exceptions to the general rules that dictate ordinary income treatment.[648]

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[641] Sec. 1222(3) and (4).

[642] See sections 475 (mark-to-market), 1233 (discussed in section C of part IV below) and 1256 (discussed in section E of part IV below).

[643] See section 1(h).

[644] See section 1(h)(1) for graduated capital gains rate information.

[645] Sec. 1211(a). A corporation with net capital losses for any taxable year may be eligible to carry such losses back three years and forward 10 years. See section 1212(a).

[646] Sec. 1211(b). Taxpayers other than a corporation may carryover their net capital losses to future years until the loss is used. The character of the loss (as either short or long-term) also is retained. See section 1212(b).

[647] See section 1(h)(11).

[648] See, *e.g.*, section 1221 (hedging transactions).

Source of income rules

When a resident of one country derives income connected with activities or investment in another country, the income could be subject to tax in both countries. U.S. law and other countries' tax laws include provisions intended to relieve this double taxation. These provisions include rules for determining whether an item of income has a domestic or a foreign source. In the United States these source-of-income rules affect U.S. and foreign taxpayers differently. The U.S. source rules matter for foreign taxpayers because the United States generally imposes tax only on the U.S.-source income of foreign taxpayers. The U.S. source rules matter for U.S. taxpayers because, although U.S. taxpayers are subject to U.S. tax on both U.S.-source and foreign-source income, the foreign tax credit, which mitigates double taxation of a U.S. taxpayer's cross-border income by giving a credit against U.S. tax for foreign tax imposed on that income, is allowed to reduce only U.S. tax on foreign-source income. Consequently, both U.S. and foreign taxpayers generally prefer that income is treated as foreign source rather than as U.S. source.

The U.S. tax rules use different factors for determining the source of different categories of income, including the residence of the payor of the income, the residence of the recipient of the income, the location or place of use of the property that produces the income, and the location of the activities that produce the income. For example, interest and dividend income generally is sourced based on the residence of the taxpayer that pays the interest or dividend; rental income is sourced based on the location of the property producing the income; royalties for the use of patents and other intellectual property are sourced based on the place of use of the property; and compensation for personal services is sourced based on where the services are performed.[649] Subject to a number of exceptions, income from the sale of personal property is sourced based on the residence of the seller of the property.[650] There are a number of special source rules, including, for example, for transportation income, space and ocean activities income, and international communications income.[651]

The Code does not provide source rules for all types of income. In the absence of a source rule for a particular kind of income, courts have determined the source of that income by applying the rule for the type of income to which the disputed income is most closely analogous.[652]

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[649] Secs. 861(a)(1)-(4), 862(a)(1)-(4).

[650] Sec. 865(a). For exceptions from the general residence-based rule, see, for example, sections 861(a)(6), 862(a)(6), 863(b)(2), and 865(b) through (e), (for inventory property income, depreciable personal property income, contingent income from intangibles, and sales through offices or fixed places of business).

[651] Sec. 863(c)(2) (50-50 U.S.-foreign source rule for income from transportation beginning or ending in the United States); sec. 863(d)(1) (space or ocean activity income sourced based on residence of the recipient of the income); sec. 863(e)(1) (50-50 rule for international communications income of U.S. persons and general foreign-source rule for the same income of foreign persons).

[652] *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

Disputes about the source of particular items of income arise regularly. Financial instruments may contribute to source disputes because their flexibility permits taxpayers to produce favorable source results by holding one instrument rather than another instrument with the same economic characteristics. Section IV.D below describes examples of source questions and their resolution (or lack of resolution).

6. Income tax rules related to five fundamental financial instruments

Equity

In general

Stock is an instrument representing an equity or ownership interest in a corporation. In its purest form, stock is risk capital entirely subject to the fortunes of the corporate venture. Stock represents the capital of the corporation that is subject to the greatest risk (compared to debt capital). The holder of stock may receive a share of the corporation's profits in the form of dividends. Appreciation or depreciation in value of the corporation's business is reflected in the price of the stock. Stock may be acquired directly upon issuance by the corporation of the stock or in the market from another holder of the stock. Federal securities laws impose registration and other requirements on publicly traded stock. Applicable Federal and State laws permit multiple classes of corporate stock with differing rights.

A partnership interest represents the partner's equity or ownership interest in capital and profits of the partnership. Unlike a corporation, a partnership is not treated as separate taxable entity, but rather, is treated as a passthrough entity for Federal tax purposes.[653] A publicly traded partnership generally is treated as a corporation for Federal tax purposes, however.[654]

Because a partnership is a passthrough entity, it is not subject to entity-level tax. Rather, income earned by a partnership, whether distributed or not, is taxed to the partners, and distributions generally are tax-free to partners. Partnership interests may be acquired directly upon issuance by the partnership or from another partner. State laws provide for general partnerships, in which partners do not have limited liability for obligations of the partnership, and limited partnerships, in which limited partners have only limited liability for obligations of the partnership. State laws also provide for limited liability companies ("LLCs"), whose members typically have limited liability. LLCs generally are treated as partnerships for Federal tax purposes.[655]

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[653] Sec. 701.

[654] Sec. 7704.

[655] An LLC is generally treated as a partnership for Federal tax purposes unless it elects to be treated as a corporation; and a single-member LLC may be disregarded as a separate entity. Treas. Reg. sec. 301.7701-3.

Timing

Realization and recognition

The realization requirement generally applies throughout the Federal income tax law. The realization requirement provides that changes in the value of property are generally ignored for Federal income tax purposes until the occurrence of a taxable event such as sale or exchange of the property. Upon the occurrence of the taxable event, gain or loss with respect to the property is considered to have been realized. A sibling concept is that of recognition. Gain or loss generally is considered to be recognized, and is taken into account for Federal income tax purposes, when it is realized, unless a specific nonrecognition rule applies that defers or permanently excludes or disallows the gain or loss.[656]

Timing of gain and loss from stock

If an instrument is treated as stock for Federal income tax purposes, gain or loss with respect to the stock is recognized at the time of a taxable sale or exchange in accordance with the holder's method of accounting. Whether an exchange is a taxable event depends in part on the type of entity or person disposing of the stock, and the nature of the transaction.[657]

In otherwise taxable transactions, the wash sale rule defers the recognition of losses in situations involving sales and reacquisitions of stock.[658] More specifically, the wash sale rule disallows losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after the date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to take account of the disallowed loss. Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities if substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Mark-to-market timing rules apply to dealers, and electively to traders, in securities. In the case of a dealer in securities, including stock, any security that is not inventory and that is held at year end is treated as if it were sold at year end at its fair market value.[659] An election for

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[656] For a detailed analysis of the concepts of realization and recognition, see, for example, Daniel N. Shaviro, "An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax," *Tax Law Review,* vol. 48, p.1, 1992.

[657] For example, if the person disposing of the stock is a tax-exempt organization, gain or loss on the sale or exchange of stock is not recognized so long as the unrelated business income tax rules do not apply in the situation (secs. 501, 511-515). As another example, nonrecognition rules may apply when stock is exchanged in a transaction constituting a tax-free corporate reorganization (sec. 368) or in another type of corporate transaction to which nonrecognition is accorded such as in a contribution of property by persons in control or in a spinoff (secs. 351, 355).

[658] Sec. 1091.

[659] Sec. 475.

traders in securities provides that electing taxpayers recognize gain or loss on securities held in that connection as if the securities were sold at year end for fair market value.[660]

Timing of dividends from stock

A dividend is generally includable in income when received, without regard to the method of accounting of the recipient.[661] No distinction is made between cash method and accrual method taxpayers for this purpose.[662]

Timing of gain or loss from sale or exchange of partnership interests

A partner that sells or exchanges its partnership interest recognizes gain or loss at the time determined under the partner's method of tax accounting. Thus, a partner who is an individual using the cash method of accounting generally takes account of gain or loss on receipt of the consideration. An accrual method partner (such as a corporate partner) takes account of gain or loss from sale or exchange of a partnership interest when received or accrued.

Timing of income or loss from partnership interests

A partner takes into account on its tax return its distributive share of separately stated partnership items and of the partnership's nonseparately stated taxable income or loss. In computing the taxable income of a partner, the inclusions are based on the income, gain, loss, deduction or credit of the partnership for the taxable year of the partnership ending within or with the taxable year of the partner.[663]

Character

Character of gain and loss from stock

Gain or loss recognized on the sale or exchange of stock held as a capital asset (*e.g.*, for investment) is generally capital gain or loss.[664]

Net capital gain of an individual is generally taxed at rates lower than those applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. An individual holder of stock treats gain or

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[660] Sec. 475(f).

[661] Treas. Reg. Sec. 1.301-(1)(b). In the case of amounts treated as corporate distributions under section 305, however, specific timing rules apply. Sec. 305(c).

[662] Dividends on stock (unlike interest on debt) are not deductible by the corporation paying the dividend, so the issue of matching the timing of the deduction of the payor and the income inclusion of the recipient generally does not arise for dividends.

[663] Sec. 706.

[664] Sec. 1221.

loss as long-term, rather than short-term, if the stock is held for more than one year. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.[665]

A dealer in securities, including stock, however, must compute its income using the mark-to-market method of accounting.[666] Gain or loss taken into account under these provisions is generally treated as ordinary gain or loss.

Under the mark-to-market rules for dealers in securities, any security that is inventory must be included in inventory at its fair market value, and for any security that is not inventory and that is held at year end, gain or loss is recognized as if it were sold for its fair market value. There is an exception to mark-to-market treatment for any security identified as held for investment or not held for sale to customers (or a hedge of such a security). For this purpose, a dealer in securities is a person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, a security is any stock in a corporation, any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, any note, bond, debenture, or other evidence of indebtedness, an interest rate, currency, or equity notional principal contract, any evidence of an interest in, or a derivative financial instrument of any security described above, and certain positions identified as hedges of any of the above.[667]

Character of dividends from stock

Dividends are treated as ordinary income.[668]

Qualified dividends received by individuals are taxed at the same rates that apply to net capital gain, however, for taxable years beginning before 2013. Thus, for taxable years beginning before 2013, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income that otherwise would be taxed at a 10- or 15-percent rate (under the ordinary income rates applicable to individuals) if the

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[665] Secs. 1, 1211 and 1222.

[666] Sec. 475.

[667] Sec. 475(c).

[668] Under the rules of subchapter C of the Code, a dividend is a distribution from the earnings and profits of a corporation. Corporate distributions that exceed corporate earnings and profits are treated first as return of capital to the extent of the shareholder's basis, and then as capital gain to the extent the distribution exceeds basis. Secs. 301(c) and 316.

special rates did not apply. Qualified dividend income generally includes dividends received from a domestic corporation.[669]

A corporate taxpayer may partially or fully deduct dividends received from a domestic corporation,[670] effectively reducing the rate of tax on the dividend income. The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns. Generally, the percentage is 100 percent for dividends received from a member of the same affiliated group (which generally requires ownership of at least 80 percent of the total voting power and total value of the stock of the corporation); the deduction percentage is 70 percent if the ownership percentage is less than 20 percent and the deduction percentage is 80 percent otherwise.[671]

Character of gain or loss from sale or exchange of partnership interests

Gain or loss from the sale or exchange of a partnership interest is generally capital gain or loss.[672] 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.[673]

Character of income or loss from partnership interests

The character of partnership items passes through to the partners, as if the items of income, gain, or loss were realized directly by the partners.[674] 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

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[669] Qualified dividend income also includes dividends received by an individual from a qualified foreign corporation, which includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines to be satisfactory and that includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend it pays with respect to stock that is readily tradable on an established securities market in the United States.

[670] Sec. 243 *et seq*. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders so the corporate-level tax is not paid repeatedly on the same income item.

[671] Secs. 243-246A provide rules and impose limitations with respect to the dividends received deduction. Additional limitations on the dividends received deduction apply under other provisions; for example, see the insurance company proration rules of secs. 805(a)(4) and 832(b)(5)(B)-(E).

[672] Sec. 741.

[673] Sec. 751(a). These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership.

[674] Sec. 702.

eligible for capital gain 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.

Source

Source of gain and loss from stock

Capital gain or loss from the sale or exchange of stock is generally sourced based on the residence of the taxpayer.[675] Thus, U.S. persons typically recognize U.S.-source gain or loss, and non-U.S. persons typically have foreign-source gain or loss. Exceptions to this residence-based source rule apply in the case of sales of stock of foreign affiliates and other foreign corporations; gain from such sales is sourced outside the United States.[676]

Source of dividends from stock

In general, dividend income is sourced based on the residence of the taxpayer that pays the dividend. Dividends from domestic corporations are generally U.S. source.[677] A pro rata portion of dividends from a foreign corporation are U.S. source, unless less than 25 percent of its gross income for the preceding three years is (or is treated as) effectively connected with the conduct of a trade or business within the United States and thus subject to U.S. income tax.[678]

Source of gain or loss from sale or exchange of partnership interests

In determining the source of gain or loss from the sale or exchange of a partnership interest, IRS administrative guidance has taken the approach of looking through the partnership interest to the partnership fixed place of business or assets. The IRS has concluded that a foreign partner's income from the sale of an interest in a partnership engaged in a U.S. business through a fixed place of business is U.S. source and that a U.S. resident partner's gain from the sale of an interest in a foreign partnership the sole activity of which is building and leasing an asset abroad is foreign source.[679]

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[675] See sec. 865(a).

[676] Sec. 865(f) and (h).

[677] Sec. 861(a)(2)(A). For this purpose, a corporation electing under section 936 is not treated as a domestic corporation.

[678] Sec. 861(a)(2)(B). Additional special source rules apply to dividends paid by foreign corporations. See, for example, section 861(a)(1)(C) and (D).

[679] Priv. Ltr. Rul. 9142032 (July 23, 1991); Rev. Rul. 91-32, 1991-1 C.B. 107. See secs. 865(e) and (i) and sec. 875(1).

Source of income or loss from a partnership interest

There is no single source rule for income paid or received by a partnership or by a partner of the partnership. Consequently, the source of partnership-related income depends on the nature of the income.

For example, there are specific source rules for a partnership's income from the sale of personal property, for interest paid by a foreign partnership, and for income from services performed by a partnership. Although the residence of the partnership (as opposed to the residence of the partners) may determine the source of partnership income that is of a type sourced by reference to the residence of the recipient of the income, the source of income from a partnership's sale of personal property is generally determined by applying the applicable section 865 source rule at the partner level.[680] Interest paid by a foreign partnership is U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is effectively connected with the conduct of a U.S. trade or business.[681] A partnership's compensation for services is U.S. source to the extent the compensation is attributable to labor or personal services performed in the United States, as determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances, typically apportionment on a time basis.[682]

Debt

In general

In its purest form, debt is an unqualified promise to pay a sum certain on a specified date with fixed interest. The holder of debt is a lender and is normally entitled to repayment of the amount loaned. The debt holder receives compensation for the use of money in the form of interest. Appreciation or depreciation in the value of the debt arises from changes in prevailing interest rates and in the creditworthiness of the borrower.

A bond is an instrument representing a debt obligation. Corporate bonds represent the debt of a corporation. Bonds may be acquired directly from the issuing corporation upon issuance of the bond or in the market from another holder of the bond. Federal securities laws impose registration and other requirements on publicly traded bonds. Applicable Federal and State laws permit multiple classes of corporate debt with differing rights.

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[680] Sec. 865(i).

[681] Sec. 861(a)(1)(B).

[682] Treas. Reg. sec. 1.861-4(b)(1)(i). This rule also applies to services performed by other entities such as corporations.

Timing

Gain and loss from bonds

If an instrument is treated as corporate debt for Federal income tax purposes, such as a bond, gain or loss with respect to the bond is recognized at the time of a taxable sale or exchange in accordance with the taxpayer's method of tax accounting. Issuance and repayment of the debt are generally not treated as taxable events. As is the case with corporate stock,[683] whether an exchange is a taxable event depends in part on the type of entity or person disposing of the bond, and the nature of the transaction.

Interest on bonds

Interest income is generally includable when received (in the case of taxpayers using the cash method of accounting, which includes almost all individuals) or when accrued (in the case of accrual method taxpayers). Interest on tax-exempt bonds, however, is not includable in income.[684]

The holder of a debt instrument with OID generally accrues OID over the life of the obligation.[685] This OID timing rule applies even though the includable amount of interest may not be received until the subsequent maturity of the instrument. The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period.

Statutory limitations on the deductibility of interest expense apply in some cases in which an immediate deduction would produce a mismatching of income and expense. If the full interest deduction is not permitted on a current basis, the deduction may be disallowed, deferred until a later time, or required to be capitalized into the basis of related property. For example, section 263A generally denies a current deduction for costs incurred in manufacturing or constructing tangible property, requiring that such costs be capitalized. Section 263(g) requires taxpayers to capitalize certain otherwise deductible expenditures, including interest expense, that are allocable to personal property that is part of a straddle.[686]

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[683] The person disposing of the bond may be a tax-exempt organization or a foreign person not subject to U.S. tax on the transaction. Under nonrecognition rules permitting the tax-free exchange of securities for securities in a corporate reorganization (sec. 368), a bond with a maturity of at least five years is generally considered a security for this purpose.

[684] Sec. 103. The outstanding market value of municipal securities as of the end of 2010 is $2.9 trillion, as shown in Table A.1 in the appendix to this document.

[685] Sec. 1272.

[686] These limitations are discussed in more detail in Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

Character

Character of gain and loss from bonds

Gain or loss recognized on the sale or exchange of a bond held as a capital asset (*e.g.*, for investment) is generally capital gain or loss.[687]

Character of interest on bonds

Interest is treated as ordinary income.

Source

Source of gain and loss on bonds

Gain or loss from the sale or exchange of a debt instrument is generally sourced based on the residence of the taxpayer.[688] Thus, U.S. persons typically recognize U.S.-source gain or loss, and non-U.S. persons typically have foreign-source gain or loss, on the sale or exchange of a debt instrument.

Source of interest on bonds

In general, interest income is sourced based on the residence of the person that pays the interest. Interest on interest-bearing obligations (such as bonds) of domestic corporations is sourced in the United States.[689] Interest on deposits with a foreign commercial banking branch of domestic corporation, however, is treated as foreign-sourced.[690]

Options

In general

An option is a contract between two parties that gives the holder of the option the right, but not the obligation, to buy from, or sell to, the counterparty a specified amount of property at a fixed price (the "strike price") at a specified time. The party with the choice to buy (or sell) the underlying property is commonly referred to as the "holder" or "buyer" of the option. The party with the matching obligation to sell (or buy) the underlying property is commonly referred to as the "writer," "seller," or "issuer" of the option. A contract giving the holder the option to buy something is referred to as a call option (or a "call").[691] A contract giving the holder the option

[687] Sec. 1221.

[688] See sec. 865(a).

[689] Sec. 861(a)(1). This rule was amended in 2010 to strike the 80-percent foreign business test. See Pub. L. No. 111-226, sec. 217.

[690] Sec. 861(a)(1)(A).

[691] A "warrant" is a call option that is written by a corporation on its own stock.

to sell something is referred to as a put option (or a "put"). An option can specify a particular date for performance (a "European-style option") or can allow for performance at any time during a specified period of time (an "American-style option").

The option buyer pays the writer a premium for the option. Traditionally, most options are structured with prepaid premiums. That is, the holder pays the option premium at the inception of the contract.

The amount of the premium varies with the strike price, the term of the option, the volatility of trading prices for the underlying asset, cash flow generated by the underlying asset (if any), and interest rates. Very generally, in the case of a call option to buy stock, the premium increases as the strike price decreases, the term of the option is set longer, or the trading price of the underlying stock becomes more volatile. Options may be physically settled, meaning the underlying asset is delivered at settlement, or net cash settled, meaning that one party pays cash at settlement equal to the difference between the strike price of the option and the value of the underlying asset.

A call option can represent the purchaser's expectation that the value of the underlying asset will increase (and the writer's expectation that the price of the underlying asset will fall or, alternatively, that it will not rise to the level of the strike price).

Example 1.–European-style, net cash-settled call option. Party A purchases a European-style, net cash-settled call option on a single share of XYZ stock from Party B (the issuer) on December 1, 2011, when XYZ is trading at $100 per share. To purchase the option, Party A pays a nonrefundable premium to Party B. The option requires Party B to pay Party A the amount (if any) by which the market price of XYZ on the settlement date exceeds $110. Suppose the value of XYZ stock on the settlement date is $150. Party B pays Party A $40. Conversely, if the value of XYZ is $105 on the settlement date, the option expires unexercised.

A put option can represent the purchaser's expectation that the price of the underlying asset will fall (and the writer's expectation that the price of the underlying asset will increase or, alternatively, that it will not fall to the level of the strike price).

Example 2.–European-style, physically-settled put option. Party A purchases a physically settled, European-style put option on a single share of XYZ stock from Party B (the issuer) on December 1, 2011, when XYZ stock is trading at $100 per share. The option gives Party A the right (but not the obligation) to sell one share of XYZ stock to Party B on December 31, 2012, for $100.[692] If the price of a share of XYZ is below $100 on the settlement date, Party A exercises the option and requires Party B to buy the XYZ share for $100. However, if the price of XYZ stock increases, Party A will not exercise the option because he could obtain a better price selling the stock in the market. The option therefore expires and Party B profits to the extent of the premium Party A paid. For example, assume that on the settlement date the price of one share of XYZ is $90. Party A exercises his option and requires Party B to purchase

[692] This option is referred to as an "at-the-money" put option; that is, one where the strike price equals the market price for XYZ stock at inception.

a share for $100. Since Party A can acquire a share in the market for $90 and immediately sell it to Party B for $100, Party A profits by $10 (less the amount of option premium that Party A paid to Party B).[693]

Timing

In general, gain or loss from options on stock is recognized on an open transaction basis. The option holder capitalizes the cost of the option premium, and the option writer does not immediately include it in income.[694] Instead, the amount of gain or loss is determined at the time of a subsequent recognition event, that is, when the option is exercised or sold or when it expires unexercised.[695]

For instance, the purchaser of a cash-settled call option determines gain or loss at the time the option is exercised by subtracting the option premium from the amount (if any) received from the writer of the option. In contrast, if the same option were physically settled, recognition of gain or loss for the holder is deferred until the acquired underlying asset is itself sold or exchanged. The premium paid to acquire the option is added to the basis of the acquired underlying asset (along with the strike price) at the time of exercise.[696] For the writer of a call option, the premium is taken into income at the time the option is exercised or expires.

Special rules apply to options that qualify as section 1256 contracts.[697] These include options on broad-based equity indices (such as an option on the S&P 500 index). In general,

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[693] Party A could take a similar position by "shorting" XYZ stock. Party A would establish a short sale by borrowing one share from a broker and selling it into the market. To close his short position, Party A delivers a share of the stock to the broker (which may be worth more or less than the amount Party A received when Party A sold the share short). If the price of the stock falls, Party A can close the short sale by purchasing stock in the market for less than the price at which it previously sold the borrowed shares. If the stock price rises, Party A spends more to close the short position than it obtained by selling the stock short. In a "naked" short sale, the investor sells shares short without first having borrowed them. In that case, the short seller must go into the market and acquire shares to deliver at settlement (generally three days following the trade date). Failure to obtain replacement shares can result in a "failure to deliver." SEC Rule 204 of Regulation SHO under the Securities and Exchange Act of 1934 requires broker-dealers to promptly borrow or purchase securities to deliver on a short sale. The down side risk of a put option is limited to the premium paid. In contrast, a short position has a potentially unlimited down side risk because there is no limit to how much the price of shorted stock might increase. For this reason, a put option may be a more attractive financial instrument for some investors.

[694] See Rev. Rul. 78-182, 1978-1 C.B. 265.

[695] *Ibid*.

[696] *Ibid*.

[697] A "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract. Sec. 1256(b)(1). The term does not include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement. Sec. 1256(b)(2). The special rules for section 1256 contracts are discussed in greater detail below.

section 1256 requires taxpayers to treat each section 1256 contract as if it were sold (and repurchased) for its fair market value on the last day of the year (*i.e.*, "marked to market"). Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as short-term capital gain or loss to the extent of 40 percent of the gain or loss, and long-term capital gain or loss to the extent of the remaining 60 percent of the gain or loss (the "60/40 rule").

Character

Gain or loss attributable to the sale or exchange of an option, or loss attributable to failure to exercise an option by the purchaser of an option, is considered to have the same character as the property to which the option relates in the hands of the option purchaser (or would have if acquired by the purchaser).[698] Thus, in the case of a purchaser of an option on publicly traded stock as an investment, gain or loss is capital. Different results are obtained if the purchaser is a dealer in securities, a taxpayer uses the option as a hedging contract, or a corporation purchases an option on its own stock. In the case of an option writer, gain or loss from delivery is typically capital (unless the option is granted in the ordinary course of the taxpayer's business). That gain or loss may be affected by the straddle rules of section 1092.[699]

For the writer of an option, gain or loss from the termination of the option (other than through delivery of the underlying asset), and any gain on a lapse of the option typically is treated as short-term capital gain or loss, regardless of the term of the contract.[700]

Source

The Code does not provide rules for the source of income from trading in options (including, for example, income from the lapse of an option or gain or loss from the sale of an option). Instead, as part of a broad revision to the source rules in 1986, Congress directed the Secretary of the Treasury to prescribe necessary or appropriate regulations applying the source rules for personal property sales to income derived from trading in futures contracts, forward contracts, options contracts, and other instruments.[701] Treasury has not yet issued such regulations. In the absence of rules addressing the source of income from trading in options, the source of this income is generally determined by analogy to existing source rules for income from sales of personal property. Under section 865, income from the sale of personal property is generally sourced based on the residence of the taxpayer, but there are many exceptions to that general rule, including for sales of inventory property and for sales attributable to a U.S. or foreign office or other fixed place of business.

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[698] Sec. 1234.

[699] The rules of section 1092 are discussed below.

[700] Sec. 1234(b)(1).

[701] Sec. 865(j).

Forward contracts

In general

A forward contract is a bilateral executory contract pursuant to which the forward buyer agrees to purchase from the forward seller a fixed quantity of property at a fixed price (the "forward price") on a fixed future date (the "delivery date"). In a traditional, postpaid forward contract, neither party to the contract makes a payment at the time the contract is executed; payment and delivery occur on the fixed future date.[702] A prepaid forward contract requires the forward buyer to pay the forward seller the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[703]

A forward contract can represent the forward buyer's expectation that the price of the underlying property will increase and the forward seller's expectation that the price will fall. Like options, forward contracts can be physically settled (settlement by delivery of the underlying asset) or net cash settled (settlement by a payment in cash equal to the difference between the contract price and the then-current price at the time the contract expires) or either, at the option of one of the parties.

A futures contract is a forward contract that is standardized and traded on an organized futures exchange, such as the Chicago Mercantile Exchange. The exchange acts as the counterparty to every transaction. As a result, every trade on the futures exchange effectively results in two contracts: one between the forward buyer and the exchange, and the other between the forward seller and the exchange. The parties to a futures contract post variation margin, an amount adjusted daily to reflect the extent to which the position of a futures contract buyer or seller is "in the money" (*i.e.*, has an unrealized profit) or "out of the money" (*i.e.*, has an unrealized loss).

Example 3.–Net cash-settled, forward contract. On December 1, 2011, when XYZ stock is trading at $100 per share, Party A, the forward seller, enters into a net cash-settled forward contract with Party B, the forward buyer, for the forward sale of one share of XYZ stock at a forward price of $106 on December 31, 2012. If the price of XYZ stock on the settlement date is above the forward price, the contract requires Party A to pay Party B the excess of the market price over $106. If the price is below $106 on December 31, 2012, Party B is required to pay Party A the amount by which $106 exceeds the market price.

Current prices of forward and futures contracts and current prices of underlying assets provide similar information about expectations of future prices. Under standard arbitrage theory,

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[702] Although payment of the forward purchase price is not made, the parties may make arrangements for the posting of collateral.

[703] Prepaid forward contracts were relatively uncommon in the markets until the development of publicly traded forward (not futures) contracts some 20 years ago. See, *e.g.*, Douglas H. Walter and Stephanie E. Balcerzak, "Innovative Transactions: Salomon Phibro Crude Oil Trust," vol. 69 *Taxes* (July 1991), p. 416 (describing the offering of a five-year, oil-based prepaid forward contract by Salomon Brothers and its subsidiary, Phibro Energy, Inc.).

the price under a traditional forward or futures contract for a nonperishable, storable commodity (gold, for example) or a traded financial instrument is determined by the item's current spot price at the time the contract is executed, plus the cost to carry the item for the term of the contract (a time value of money return on the cash that would be invested in acquiring the item at execution of the contract and holding it until the final delivery date, together with any warehousing or similar expenses), minus the expected cash yield on the item (for example, expected dividends if the item is corporate stock) over the term of the contract.[704] For example, if one share of stock in Company XYZ costs $100 today, the one-year interest rate is six percent, and XYZ is expected to pay $4 per share in dividends over the coming year, the one-year forward price of one share of XYZ stock would be $102 ($100 plus six percent interest minus $4 yield). If XYZ stock paid no dividend (or instead XYZ stock was a precious metal or foreign currency), the forward price would be $106, reflecting the time value of money.[705]

In each case, the forward price reflects the current spot price, plus the cost to carry, minus projected cash returns over the contract term. If forward prices were higher than that predicted by this model, then arbitrageurs could earn riskless profits by buying the property today with borrowed funds and selling it forward for more than the net cost of the financing and storage. If forward prices were lower, arbitrageurs would sell the property short today, invest the cash proceeds at current interest rates, and buy the property forward to later close the short sale.

Example 4.–Prepaid forward contract. Assume the forward price under a traditional (postpaid) forward contract for one share of XYZ stock on December 31, 2012, is $106. Assume XYZ today does not pay dividends and XYZ stock today trades at $100 per share. On December 1, 2011, Party A and Party B enter into a net cash-settled, prepaid forward contract. Party B, the forward buyer, pays Party A $100 (which is both the current trading price of XYZ stock and the present value on December 1, 2011, of a $106 payment on December 31, 2012). On the settlement date, Party A pays Party B the value of XYZ stock on that date.

Both a traditional postpaid forward contract and a prepaid forward contract afford the buyer the economic return on the asset underlying the contract. If the underlying asset has a current cash yield, then the seller in a prepaid forward contract passes that expected yield to the buyer in the forward price. If the underlying asset does not have a current cash yield (like the share of XYZ stock that does not pay dividends), then the forward price reflects only the spot price of the asset plus any warehousing or similar expenses, and the transaction is similar to a current cash sale.

The forward buyer in a prepaid forward contract pays for the item at the outset. In contrast with a traditional postpaid forward contract, the seller of a prepaid forward contract has use of the buyer's money during the term of the prepaid forward contract. The amount paid to the buyer at settlement thus includes compensation to the buyer for the time value of money. In Example 4, if the price of XYZ stock on December 31, 2012, is $110, Party A pays Party B

[704] Storage of physical assets such as gold (in a vault) or wheat (in a silo) involves actual storage cost; the storage cost for financial assets like stock or Treasury bills is generally expected to be *de minimis*.

[705] These examples ignore storage costs and minor timing differences in the cash flows.

$110, $6 of which compensates Party B for the use of $100 during the term of the contract. If Party B had invested the $100 at prevailing interest rates on December 1, 2011, he would have had $106 on December 31, 2012. The additional $4 that Party A pays Party B represents the additional return on XYZ stock relative to prevailing interest rates.

Timing

The execution of a forward contract generally has no immediate income tax consequences. Like an option, a standard forward contract is an executory contract and is treated as an open transaction until the contract is settled. If a forward contract is settled by delivery of the property underlying the contract, the taxpayer delivering the property recognizes gain or loss based on the difference between the price received and the taxpayer's basis in the property.[706] The forward purchaser, by contrast, reflects the contract price as the basis for the property so acquired; gain or loss (if any) is deferred until the time of a subsequent sale or exchange of the property. The fact that a prepaid forward contract calls for payment by one party to the other party at the time the contract is executed has not been treated as changing the tax treatment of the contract.[707]

Futures contracts traded on futures exchanges are generally treated as "section 1256 contracts" and are subject to a mark-to-market regime and special character rules. As applied to equity futures contracts held by investors, the rules of section 1256 apply primarily to futures contracts on broad-based indices; single-stock futures contracts are governed by a different set of rules in section 1234B.[708] Different rules can apply to section 1256 contracts held as part of a hedging transaction or a mixed straddle.

Character

The character of the gain or loss with respect to a forward contract generally is the same as the character of the property delivered. If the underlying asset is delivered, the forward buyer does not immediately recognize gain or loss, but is treated as having purchased the property with a basis equal to the purchase price. The forward seller recognizes gain or loss equal to the difference between his basis and the forward price. The character of the forward seller's gain

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[706] Sec. 1001.

[707] *Cf.* Rev. Rul. 2003-7, 2003-1 C.B. 363 (Feb. 3, 2003) (holding that a shareholder of a publicly traded corporation who entered a variable prepaid forward contract on such stock with an investment bank and pledged the maximum number of shares that might be required to be delivered was not considered to have sold or constructively sold the stock where the amount of stock to be delivered in the future varied significantly depending on the value of the shares on the delivery date, the taxpayer retained an unrestricted legal right to substitute cash or other shares for the pledged shares, and the taxpayer was not economically compelled to deliver the pledged shares).

[708] Section 1234B provides that gain or loss attributable to the sale, exchange, or termination of a securities futures contract shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the taxpayer's hands. Section 1234B also provides that gain or loss on a securities futures contract, if capital, is treated as short-term capital gain or loss.

generally depends upon the character of the property delivered.[709] If a forward contract is settled by a cash payment, or is cancelled or otherwise terminated, the gain or loss is capital if the underlying asset is capital in nature.[710] If a forward contract is sold, the character of the gain or loss is generally capital if the forward contract is a capital asset in the hands of the selling taxpayer.

As mentioned above, certain traded futures contracts qualifying as section 1256 contracts are subject to a mark-to-market regime and special character rules. Capital gain or loss with respect to a section 1256 contract is treated as long-term capital gain or loss to the extent of 60 percent of the gain or loss and short-term capital gain or loss to the extent of 40 percent of the gain or loss, regardless of the investor's holding period. Different rules can apply to section 1256 contracts held as part of a hedging transaction or a mixed straddle.

Source

The Code does not provide rules for the source of income from trading in forward contracts (including for example, gain or loss from the sale of a forward contract). Instead, Congress directed the Treasury Secretary to prescribe necessary or appropriate regulations applying the source rules for personal property sales to income derived from trading in futures contracts, forward contracts, options contracts, and other instruments.[711] Treasury has not yet issued regulations. In the absence of rules addressing the source of income from trading in forward contracts, the source of this income is generally determined by analogy to existing source rules for income from sales of personal property. Under section 865, income from the sale of personal property is generally sourced based on the residence of the taxpayer, but there are many exceptions to that general rule, including for sales of inventory property and for sales attributable to a U.S. or foreign office or other fixed place of business.

Notional principal contracts

Treasury regulations define a NPC as a financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[712] A specified index is defined as a fixed rate, price or amount that must be based on objective financial information not in control of either party. A notional principal amount is defined as a specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties. The regulations exclude certain instruments from the

[709] The character of gain or loss recognized by a forward seller may be affected by the tax straddle and short sale rules of sections 1092 and 1233, respectively.

[710] Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

[711] Sec. 865(j).

[712] Treas. Reg. sec. 1.446-3(c)(1)(i). The definition of an NPC covers instruments commonly referred to as swaps, but that term is not defined in the Code.

definition of NPC including: (1) section 1256 contracts, (2) futures contracts, (3) forward contracts, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.[713]

A traditional interest rate swap is an example of an NPC. Pursuant to such a swap, one party typically agrees to make payments to the other based on a fixed interest rate (*e.g.*, five percent) applied to a notional amount (*e.g.*, $1 million) at regular intervals (*e.g.*, quarterly for two years). In return, the other party agrees to make interest payments based on a variable, or floating, interest rate (*e.g.*, the London Interbank Offered Rate ("LIBOR")) applied to the same notional amount at the same intervals. The $1 million notional amount is used only to calculate the payments required by each party, and does not itself change hands. Amounts owed by the parties are typically netted, so that only a single payment is made on any given payment date.

A traditional interest rate swap can reflect one party's expectation that the payments of a floating interest rate will exceed a specified fixed interest rate (or vice versa) over the term of the contract. These contracts can be understood as the economic equivalent of back-to-back loans of the notional amount. Interest rate swaps can also be understood as a series of cash-settled forward contracts that have been leveled. For example, to replicate the swap, the two parties could enter a series of cash-settled forward contracts on short-term deposits, one paying the fixed rate of interest and the other paying the floating rate of interest. The parties would enter two cash-settled forward contracts for each quarter end.

Other swaps, like a total return swap, can be understood as the economic equivalent of making a 100-percent leveraged investment in the underlying asset. For example, an equity swap is a total return swap on a specified equity security.

Example 5.–Equity Swap. Party A agrees to make 10 payments to Party B on December 31 of each of the next 10 years, in an amount equal to the sum of: (1) the appreciation, if any, in value of 100 shares of XYZ stock during the year, and (2) dividends paid on 100 shares of XYZ stock during the year. Likewise, Party B agrees to make 10 identically timed payments to Party A, in an amount equal to the sum of: (1) the depreciation, if any, in value of 100 shares of XYZ during the year, and (2) a fixed (or floating) rate of interest multiplied by the value of 100 shares of XYZ stock at the beginning of the year. Since the payments are all due on the same day, the parties agree that all payments are netted, and only one party makes a net payment to the other.

Economically, this equity swap puts Party B in the same economic position as it would have been in if it bought XYZ stock at the inception of the swap contract from Party A with money borrowed from Party A, with an agreement to sell the stock back to Party A and repay the borrowing at the end of the 10-year period. Party B incurs the same costs (expressed as the interest on a notional principal amount), receives the same current returns (dividend-equivalent amounts), and is subject to the same market opportunities and risks (appreciation or depreciation

[713] On September 16, 2011, the Treasury Department promulgated proposed amendments to the income tax regulations under sections 1256 and 446 of the Code (Notice of Proposed Rule Making, Fed. Reg. Vol. 76, No. 180, p. 57684). The proposed amendments affect the scope of the term "section 1256 contract" and revise the scope of the notional principal contract regulations under section 446.

in the value of the stock). An equity swap and a leveraged purchase are not, however, identical in every respect. For example, the parties to an equity swap are exposed to the credit worthiness of their counterparties. The holder of an equity swap does not have any of the legal rights that attach to actual stock ownership such as the right to vote on corporate matters or the rights to corporate property upon liquidation. In addition, current securities laws limit leveraged margin purchases to 50 percent of the value of the underlying security.[714] The leverage implicit in an equity swap, however, is not subject to securities margin rules.

Both the interest rate swap and the equity swap described above are common derivative contracts, and both qualify as NPCs under Treasury regulations. Swaps are not, however, limited to interest rates or equities. The variety of possible swaps is limited only by the imagination and investment objectives of parties willing to enter such contracts.

Timing

Regulations promulgated under section 446 require that the parties to an NPC classify each payment pursuant to the contract as either: (i) a periodic payment; (ii) a nonperiodic payment; or (iii) a termination payment.[715] Each type of payment is treated differently. Taxpayers generally must recognize (as income or deduction, whichever is relevant) the ratable daily portions of all periodic and nonperiodic payments for the taxable year to which that payment relates, and must recognize a termination payment in the year the NPC is extinguished, assigned, or terminated (*i.e.*, in the year the payment is made).[716] A swap with a significant nonperiodic payment is treated as two separate transactions consisting of an on-market level payment swap and a loan. The loan must be accounted for independently of the swap. Under proposed regulations, contingent nonperiodic payments (such as a single payment tied to the increase or decrease in the value of the underlying asset) are accrued over the term of the swap based on an estimate of the amount of the payment.[717] The amount of a taxpayer's accrual is periodically redetermined as more information about the expected amount of the noncontingent payment becomes available.[718]

Character

Unlike the character of the income recognized from options and forwards, which typically is determined with reference to the character of gains and losses that result from a

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[714] See 12 C.F.R. 220 (Regulation T, establishing securities margin rules for securities brokers and dealers), 12 C.F.R. 221 (Regulation U, establishing securities margin rules for commercial banks that are not securities brokers or dealers), and 12 C.F.R. 224 (Regulation X, establishing securities margin rules for loans not covered by Regulations T or U).

[715] Treas. Reg. sec. 1.446-3(e), (f) and (h).

[716] *Ibid*.

[717] See Prop. Treas. Reg. sec. 1.446-3.

[718] *Ibid*.

taxpayer's transactions with respect to the underlying asset, the character of NPC payments is generally not determined by the character of the underlying asset. Final Treasury regulations do not directly address the tax character of each type of payment made under an NPC. However, proposed Treasury regulations issued in 2004 under section 1234A provide that any payment on an NPC other than a termination payment (*i.e.*, a periodic or nonperiodic payment) generally constitutes ordinary income or expense.[719] The preamble to the proposed regulations explains that ordinary income is warranted because neither periodic nor nonperiodic payments involve the sale or exchange of a capital asset. In contrast, the proposed regulations provide that, by application of section 1234A, gain or loss attributable to the termination of a swap contract would be capital if the contract is a capital asset in the hands of the taxpayer.[720] The proposed regulations state that final settlement payments with respect to an NPC are not termination payments under section 1234A.[721]

Source

To the extent a payment is not otherwise treated as a dividend equivalent payment under section 871(m), income from an NPC is generally sourced by reference to the residence of the recipient, unless the income is effectively connected with a U.S. trade or business.[722] Consequently, a foreign person's income related to an NPC referencing stock of a U.S. corporation, including amounts attributable to dividends paid on the stock, is generally foreign source income and exempt from U.S. withholding tax.

Under special rules described in section IV.D. below, some payments to foreign persons on some NPCs are treated as U.S.-source dividend equivalent payments subject to U.S. withholding tax.

Summary Table

The following table summarizes the general rules with respect to timing, character, and source of income and gain or loss with respect to each of the foregoing types of instruments. Exceptions to the general rules apply in many instances, though these exceptions are not noted in the interest of brevity.

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[719] Prop. Treas. Reg. sec. 1.1234A-1.

[720] The proposed regulations would treat any payment on a "bullet swap" or forward contract, including payments made pursuant to the terms of the contract, as termination payments for purposes of Section 1234A. Both of these types of contracts provide for all payments to be made at or close to the maturity of the contract. Prop. Treas. Reg. sec. 1.1234A-1(c). More recent proposed amendments to the income tax regulations under sections 1256 and 446 call into question this analysis. Among other things, the proposed amendments treat the fixing of an amount as a "payment" for purposes of the definition of a notional principal contract, even if the actual payment reflecting that amount is to be made at a later date.

[721] Prop. Treas. Reg. sec. 1.1234A-1(b).

[722] Treas. Reg. sec. 1.863-7. The regulations provide exceptions for income earned through a U.S. branch and certain section 988 transactions.

Table 8.–Overview of Tax Rules for Certain Financial Instruments[1]

Instrument	Timing	Character	Source
Stock	Gain or loss deferred until taxable disposition Dividend income taken into account when received or accrued	Gain or loss long-term or short-term capital depending on holding period Dividend income ordinary (subject to long-term capital gains tax rate through 2012)[2]	Gain or loss on disposition generally taxpayer residence Dividend income generally residence of payor
Partnership interest	Gain or loss deferred until taxable disposition Partnership income taken into account in the partner's taxable year within or with which the partnership taxable year ends, regardless of whether or not distributed	Gain or loss on disposition capital except to the extent attributable to certain partnership ordinary income assets Character of partnership income determined at partnership level and passed through to partner	Gain or loss on disposition generally taxpayer residence (see discussion) Partnership income depends on nature of the income item
Debt	Gain or loss recognized at time of taxable sale or exchange Interest taken into account when received or accrued, OID accrues over life of instrument	Gain or loss on disposition capital Interest income ordinary	Gain or loss on disposition generally taxpayer residence Interest income generally residence of payor
Option	Deferred until settlement date or expiration	Capital based on sections 1234 and 1234A	See discussion
Forward Contract	Deferred until settlement date	Based on nature of underlying asset (usually capital)	See discussion
Exchange-traded futures and options	Marked to market at end of taxpayer's tax year	60 percent long-term capital and 40 percent short-term capital (unless otherwise ordinary) under section 1256, regardless of holding period	See discussion
NPC	Accrual of periodic and non-periodic payments. Gain or loss deferred until taxable disposition or early termination	Periodic and non-periodic payments generally ordinary income Termination payment capital based on section 1234A	Generally taxpayer residence on NPC income

[1] Table adapted from Stevie D. Conlon and Vincent P. Aquilino, *Principles of Financial Derivatives, U.S. and International Taxation*, Exhibit B1.1, p. B1-5 (2010). The table assumes the relevant asset is (or would be) held as a capital asset.

[2] Corporate recipients of dividends may be eligible for a dividends received deduction.

F. Present Law: Income and Tax Distribution

Part I, above, provides an overview of the principal features of the present-law individual and corporate income taxes, payroll taxes, estate and gift taxes, and excise taxes. All elements of present law play a role in determining the distribution of tax liabilities and the after-tax distribution of income. In contrast, the pre-tax distribution of income is largely determined by factors other than tax policy. Ultimately, the distribution of tax liabilities is determined by the pre-tax distribution of income combined with the policy decisions that determine the various tax bases and the tax rates to apply to those bases.

Table 9, below, shows the Joint Committee staff's estimation of the 2013 distribution of income and Federal taxes, and the average Federal tax rate, by income category. The Joint Committee staff uses a broad measure of income for this purpose, known as "expanded income." The elements of this income measure are detailed in the footnotes to the table.[723]

Table 10, below, shows the 2013 distribution of the two largest Federal revenue sources − the individual income taxes and payroll taxes − by income category. The table also shows the average income tax rate and the average payroll tax rate by income category. Table 11, below, shows similar data and the combined average Federal tax rate for these two revenue sources.

TABLE 9.–A DISTRIBUTION OF FEDERAL TAXES UNDER PRESENT LAW

Calendar Year 2013

INCOME CATEGORY (1)	Returns	EXPANDED INCOME (1)		FEDERAL TAXES (2) UNDER PRESENT LAW		Average Tax Rate (3)
	Thousands	Billions	Percent	Billions	Percent	Percent
Less than $10,000	18,661	$81	0.7%	$6	0.3%	6.8%
$10,000 to $20,000	18,504	$280	2.4%	$6	0.3%	2.1%
$20,000 to $30,000	20,522	$506	4.4%	$31	1.5%	6.1%
$30,000 to $40,000	16,146	$565	4.9%	$52	2.5%	9.3%
$40,000 to $50,000	14,700	$659	5.7%	$76	3.7%	11.5%
$50,000 to $75,000	24,411	$1,507	13.1%	$197	9.5%	13.0%
$75,000 to $100,000	16,793	$1,451	12.6%	$218	10.5%	15.0%
$100,000 to $200,000	23,884	$3,230	28.1%	$623	30.1%	19.3%
$200,000 to $500,000	5,823	$1,630	14.2%	$392	19.0%	24.1%
$500,000 to $1,000,000	702	$470	4.1%	$131	6.3%	27.9%
$1,000,000 and over	348	$1,126	9.8%	$338	16.3%	30.0%
Total, All Taxpayers	**160,494**	**$11,504**	**100.0%**	**$2,069**	**100.0%**	**18.0%**

Source: Joint Committee on Taxation

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(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.

(2) Federal taxes are equal to individual income taxes (including the outlay portion of refundable credits), employment taxes (attributed to employees) and excise taxes (attributed to consumers). The corporate income tax and the estate and gift tax are not included. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(3) The average tax rate is equal to Federal taxes described in footnote (2) divided by income described in footnote (1).

[723] For further information on this definition of income, see Joint Committee on Taxation, *Overview of the Definition of Income Used by the Staff of the Joint Committee on Taxation in Distributional Analyses* (JCX-15-12), February 8, 2012. This document can be found on our website at www.jct.gov

TABLE 10.–A DISTRIBUTION OF INCOME AND FEDERAL INDIVIDUAL INCOME AND PAYROLL TAXES UNDER PRESENT LAW

ALL FILERS

Calendar Year 2013

INCOME CATEGORY (1)	EXPANDED INCOME (1)			FEDERAL INCOME TAXES (2)				FEDERAL PAYROLL TAXES (3)			
	Returns	Dollars	Percent	Returns	Dollars	Percent	Avg. Rate (4)	Returns	Dollars	Percent	Avg. Rate (4)
Less than $10,000.....	16,159	$81.2	0.7%	6,319	-$9.2	-0.9%	-11.3%	12,641	$9.3	1.0%	11.4%
$10,000 to $20,000.....	18,498	$280.0	2.4%	13,417	-$27.6	-2.6%	-9.9%	15,283	$27.8	3.0%	9.9%
$20,000 to $30,000.....	20,531	$505.8	4.4%	13,633	-$17.1	-1.6%	-3.4%	14,622	$41.0	4.5%	8.1%
$30,000 to $40,000.....	16,152	$564.7	4.9%	12,456	-$3.1	-0.3%	-0.5%	12,767	$48.9	5.4%	8.7%
$40,000 to $50,000.....	14,694	$658.9	5.7%	12,472	$12.1	1.1%	1.8%	11,641	$56.8	6.2%	8.6%
$50,000 to $75,000.....	24,409	$1,506.7	13.1%	21,330	$56.6	5.3%	3.8%	19,655	$126.3	13.8%	8.4%
$75,000 to $100,000.....	16,793	$1,451.4	12.6%	15,999	$81.9	7.6%	5.6%	14,049	$125.4	13.7%	8.6%
$100,000 to $200,000.....	23,884	$3,229.9	28.1%	23,693	$291.0	27.2%	9.0%	21,464	$311.6	34.1%	9.6%
$200,000 to $500,000.....	5,823	$1,629.9	14.2%	5,792	$260.9	24.4%	16.0%	5,363	$124.1	13.6%	7.6%
$500,000 to $1,000,000.....	702	$470.1	4.1%	700	$109.7	10.3%	23.3%	639	$20.6	2.3%	4.4%
$1,000,000 and over.....	348	$1,125.6	9.8%	347	$314.8	29.4%	28.0%	316	$22.0	2.4%	2.0%
Total, All Taxpayers.....	**157,993**	**$11,504.1**	**100.0%**	**126,158**	**$1,070.0**	**100.0%**	**9.3%**	**128,441**	**$913.9**	**100.0%**	**7.9%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.
(2) Federal individual income taxes include the outlay portion of refundable credits.
(3) Federal payroll taxes include the employees' and employers' portions of employment taxes and SECA taxes.
(4) The average tax rate is equal to taxes divided by income described in footnote (1).

TABLE 11.–A DISTRIBUTION OF FEDERAL INDIVIDUAL INCOME AND PAYROLL TAXES UNDER PRESENT LAW

ALL FILERS

Calendar Year 2013

INCOME CATEGORY (1)	TOTAL Returns (2)	FEDERAL INCOME TAXES (3)		FEDERAL PAYROLL TAXES (4)		FEDERAL INCOME AND PAYROLL TAXES		Average Tax Rate (5)
	Returns	Returns	Dollars	Returns	Dollars	Dollars	Percent	Percent
Less than $10,000.....	18,660	6,319	-$9.2	12,641	$9.3	(6)	(7)	(7)
$10,000 to $20,000.....	18,498	13,417	-$27.6	15,283	$27.8	$0.1	(7)	0.1%
$20,000 to $30,000.....	20,531	13,633	-$17.1	14,622	$41.0	$23.9	1.2%	4.7%
$30,000 to $40,000.....	16,152	12,456	-$3.1	12,767	$48.9	$45.8	2.3%	8.1%
$40,000 to $50,000.....	14,694	12,472	$12.1	11,641	$56.8	$68.9	3.5%	10.5%
$50,000 to $75,000.....	24,409	21,330	$56.6	19,655	$126.3	$182.9	9.2%	12.1%
$75,000 to $100,000.....	16,793	15,999	$81.9	14,049	$125.4	$207.3	10.4%	14.3%
$100,000 to $200,000.....	23,884	23,693	$291.0	21,464	$311.6	$602.6	30.4%	18.7%
$200,000 to $500,000.....	5,823	5,792	$260.9	5,363	$124.1	$385.0	19.4%	23.6%
$500,000 to $1,000,000.....	702	700	$109.7	639	$20.6	$130.3	6.6%	27.7%
$1,000,000 and over.....	348	347	$314.8	316	$22.0	$336.8	17.0%	29.9%
Total, All Taxpayers.....	**160,494**	**126,158**	**$1,070.0**	**128,441**	**$913.9**	**$1,983.9**	**100.0%**	**17.2%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels
(2) Total returns includes filer and non-filers.
(3) Federal individual income taxes include the outlay portion of refundable credits. Returns are in thousands; Dollars are in billions.
(4) Federal payroll taxes include the employees' and employers' portions of employment taxes and SECA taxes. Returns are in thousands; Dollars are in billions.
(5) The average tax rate is equal to Federal income and payroll taxes divided by income described in footnote (1).
(6) Dollars less than $50,000.
(7) Percent less than 0.005%.

Tables 12, 13, and 14, below, show the distribution of Federal income and payroll taxes, and average tax rates, by income category, for single filers, joint filers, and head of household filers, respectively.

TABLE 12.–A DISTRIBUTION OF FEDERAL INDIVIDUAL INCOME AND PAYROLL TAXES UNDER PRESENT LAW

SINGLE FILERS

Calendar Year 2013

INCOME CATEGORY (1)	TOTAL Returns (2)	FEDERAL INCOME TAXES (3)		FEDERAL PAYROLL TAXES (4)		FEDERAL INCOME AND PAYROLL TAXES		Average Tax Rate (5)
	Returns	Returns	Dollars	Returns	Dollars	Dollars	Percent	Percent
Less than $10,000.....	14,331	3,517	-$2.6	9,200	$6.1	$3.5	0.7%	6.0%
$10,000 to $20,000.....	11,509	7,489	-$3.0	8,776	$15.5	$12.5	2.6%	7.2%
$20,000 to $30,000.....	13,434	7,651	$4.2	8,202	$23.0	$27.2	5.6%	8.2%
$30,000 to $40,000.....	9,567	6,802	$11.5	6,814	$26.5	$38.0	7.8%	11.4%
$40,000 to $50,000.....	8,203	7,188	$18.1	6,067	$30.6	$48.7	10.0%	13.3%
$50,000 to $75,000.....	9,529	9,160	$43.8	7,263	$50.2	$94.0	19.3%	16.3%
$75,000 to $100,000.....	3,743	3,676	$34.9	3,066	$30.6	$65.5	13.5%	20.6%
$100,000 to $200,000.....	3,119	3,084	$57.7	2,584	$37.5	$95.3	19.6%	23.4%
$200,000 to $500,000.....	629	625	$33.8	507	$9.9	$43.7	9.0%	24.5%
$500,000 to $1,000,000.....	86	85	$13.3	64	$1.8	$15.1	3.1%	26.3%
$1,000,000 and over.....	45	45	$40.7	34	$2.1	$42.8	8.8%	28.2%
Total, All Taxpayers.....	**74,191**	**49,321**	**$252.4**	**52,577**	**$233.9**	**$486.3**	**100.0%**	**16.5%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels
(2) Total returns includes filer and non-filers.
(3) Federal individual income taxes include the outlay portion of refundable credits. Returns are in thousands; Dollars are in billions.
(4) Federal payroll taxes include the employees' and employers' portions of employment taxes and SECA taxes. Returns are in thousands; Dollars are in billions.
(5) The average tax rate is equal to Federal income and payroll taxes divided by income described in footnote (1).
(6) Dollars less than $50,000.
(7) Percent less than 0.005%.

TABLE 13.–A DISTRIBUTION OF FEDERAL INDIVIDUAL INCOME AND PAYROLL TAXES UNDER PRESENT LAW

JOINT FILERS

Calendar Year 2013

INCOME CATEGORY (1)	TOTAL Returns (2)	FEDERAL INCOME TAXES (3)		FEDERAL PAYROLL TAXES (4)		FEDERAL INCOME AND PAYROLL TAXES		Average Tax Rate (5)
	Returns	Returns	Dollars	Returns	Dollars	Dollars	Percent	Percent
Less than $10,000.....	1,605	511	-$1.0	1,093	$1.0	(6)	(7)	0.2%
$10,000 to $20,000.....	2,181	1,345	-$4.4	1,785	$3.4	-$0.9	-0.1%	-2.8%
$20,000 to $30,000.....	2,989	2,083	-$5.7	2,426	$6.8	$1.1	0.1%	1.5%
$30,000 to $40,000.....	3,374	2,580	-$6.0	2,834	$10.7	$4.7	0.3%	3.9%
$40,000 to $50,000.....	4,063	2,945	-$3.4	3,216	$14.8	$11.4	0.8%	6.2%
$50,000 to $75,000.....	11,515	8,857	$7.7	9,162	$54.8	$62.5	4.4%	8.6%
$75,000 to $100,000.....	11,635	10,918	$39.9	9,610	$81.8	$121.7	8.6%	12.0%
$100,000 to $200,000.....	19,814	19,662	$219.9	17,960	$260.8	$480.7	34.0%	17.8%
$200,000 to $500,000.....	5,069	5,043	$220.3	4,741	$112.0	$332.3	23.5%	23.5%
$500,000 to $1,000,000.....	600	599	$93.8	561	$18.4	$112.2	7.9%	27.9%
$1,000,000 and over.....	295	295	$267.0	275	$19.4	$286.3	20.3%	30.2%
Total, All Taxpayers.....	**63,143**	**54,838**	**$828.2**	**53,663**	**$583.7**	**$1,411.9**	**100.0%**	**18.5%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.

Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels

(2) Total returns includes filer and non-filers.

(3) Federal individual income taxes include the outlay portion of refundable credits. Returns are in thousands; Dollars are in billions.

(4) Federal payroll taxes include the employees' and employers' portions of employment taxes and SECA taxes. Returns are in thousands; Dollars are in billions.

(5) The average tax rate is equal to Federal income and payroll taxes divided by income described in footnote (1).

(6) Dollars less than $50,000.

(7) Percent less than 0.005%.

TABLE 14.–A DISTRIBUTION OF FEDERAL INDIVIDUAL INCOME AND PAYROLL TAXES UNDER PRESENT LAW

HEAD OF HOUSEHOLD FILERS

Calendar Year 2013

INCOME CATEGORY (1)	TOTAL Returns (2)	FEDERAL INCOME TAXES (3)		FEDERAL PAYROLL TAXES (4)		FEDERAL INCOME AND PAYROLL TAXES		Average Tax Rate (5)
	Returns	Returns	Dollars	Returns	Dollars	Dollars	Percent	Percent
Less than $10,000.....	2,724	2,291	-$5.6	2,348	$2.1	-$3.4	-4.0%	-21.6%
$10,000 to $20,000.....	4,808	4,583	-$20.2	4,722	$8.8	-$11.4	-13.4%	-15.9%
$20,000 to $30,000.....	4,108	3,898	-$15.6	3,994	$11.3	-$4.4	-5.1%	-4.3%
$30,000 to $40,000.....	3,210	3,074	-$8.6	3,118	$11.8	$3.2	3.7%	2.8%
$40,000 to $50,000.....	2,428	2,339	-$2.6	2,359	$11.4	$8.8	10.3%	8.1%
$50,000 to $75,000.....	3,366	3,314	$5.1	3,230	$21.3	$26.4	30.9%	12.9%
$75,000 to $100,000.....	1,415	1,406	$7.0	1,374	$13.0	$20.1	23.4%	16.6%
$100,000 to $200,000.....	951	946	$13.4	920	$13.3	$26.7	31.2%	21.4%
$200,000 to $500,000.....	125	125	$6.8	115	$2.3	$9.0	10.6%	25.4%
$500,000 to $1,000,000.....	16	16	$2.6	14	$0.4	$3.0	3.5%	27.7%
$1,000,000 and over.....	8	8	$7.1	7	$0.5	$7.7	8.9%	29.6%
Total, All Taxpayers.....	**23,160**	**21,999**	**-$10.6**	**22,201**	**$96.2**	**$85.6**	**100.0%**	**9.2%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels
(2) Total returns includes filer and non-filers.
(3) Federal individual income taxes include the outlay portion of refundable credits. Returns are in thousands; Dollars are in billions.
(4) Federal payroll taxes include the employees' and employers' portions of employment taxes and SECA taxes. Returns are in thousands; Dollars are in billions.
(5) The average tax rate is equal to Federal income and payroll taxes divided by income described in footnote (1).
(6) Dollars less than $50,000.
(7) Percent less than 0.005%.

Tables 15 and 16, below, show the distribution of selected sources of income. Table 15 shows the distribution of wages and salaries, interest income, and dividend income. Table 16 shows the distribution of capital gains, Schedule E, and Schedule C income. Capital gains and Schedule E income are particularly concentrated in the higher income groups, as compared to wages and salaries or Schedule C income.

TABLE 15.–A DISTRIBUTION OF SELECTED INCOME SOURCES

Calendar Year 2013

INCOME CATEGORY (1)	WAGES AND SALARIES			INTEREST INCOME			DIVIDEND INCOME		
	Returns	Dollars	Percent	Returns	Dollars	Percent	Returns	Dollars	Percent
Less than $10,000.....	18,660	$49.3	0.8%	2,901	$2.0	1.6%	1,070	$1.3	0.6%
$10,000 to $20,000.....	18,498	$156.4	2.5%	2,354	$1.7	1.3%	897	$1.6	0.8%
$20,000 to $30,000.....	20,531	$252.4	4.0%	3,254	$2.5	2.0%	1,173	$2.5	1.2%
$30,000 to $40,000.....	16,152	$307.4	4.9%	4,369	$4.5	3.5%	1,785	$3.9	1.8%
$40,000 to $50,000.....	14,694	$359.1	5.7%	4,953	$5.1	4.0%	2,200	$5.1	2.4%
$50,000 to $75,000.....	24,409	$800.2	12.6%	11,020	$13.3	10.4%	5,355	$15.5	7.2%
$75,000 to $100,000.....	16,793	$791.8	12.5%	9,334	$12.3	9.6%	4,921	$16.2	7.5%
$100,000 to $200,000.....	23,884	$2,007.5	31.7%	15,807	$24.4	19.1%	9,930	$42.0	19.6%
$200,000 to $500,000.....	5,823	$1,012.6	16.0%	4,544	$18.0	14.1%	3,919	$40.1	18.7%
$500,000 to $1,000,000.....	702	$245.8	3.9%	586	$8.5	6.6%	600	$20.1	9.3%
$1,000,000 and over.....	348	$344.0	5.4%	299	$35.8	27.9%	316	$66.5	31.0%
Total, All Taxpayers.....	**160,494**	**$6,326.6**	**100.0%**	**59,420**	**$128.0**	**100.0%**	**32,167**	**$214.8**	**100.0%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.
(2) Schedule E income includes income from rental real estate, royalties, partnerships, S corporations, estates and trusts, REMICS, etc.
(3) Schedule C income is income from sole proprietorships.

TABLE 16.–A DISTRIBUTION OF SELECTED INCOME SOURCES

Calendar Year 2013

INCOME CATEGORY (1)	CAPITAL GAINS			SCHEDULE E INCOME (2)			SCHEDULE C INCOME (3)		
	Returns	Dollars	Percent	Returns	Dollars	Percent	Returns	Dollars	Percent
Less than $10,000.....	542	$0.3	0.1%	384	-$2.1	-0.3%	2,603	$11.1	3.7%
$10,000 to $20,000.....	578	$0.6	0.2%	604	-$1.4	-0.2%	3,100	$24.7	8.2%
$20,000 to $30,000.....	794	$0.6	0.2%	731	-$1.0	-0.1%	1,918	$13.0	4.3%
$30,000 to $40,000.....	1,180	$1.0	0.3%	940	$0.2	0.0%	1,728	$11.1	3.7%
$40,000 to $50,000.....	1,350	$1.5	0.4%	1,049	$1.5	0.2%	1,606	$9.7	3.2%
$50,000 to $75,000.....	3,354	$6.3	1.9%	2,577	$7.2	1.1%	3,245	$22.4	7.4%
$75,000 to $100,000.....	3,023	$7.7	2.3%	2,455	$11.0	1.7%	2,608	$20.8	6.9%
$100,000 to $200,000.....	6,488	$31.6	9.5%	4,678	$55.9	8.7%	4,307	$57.6	19.0%
$200,000 to $500,000.....	3,005	$51.1	15.4%	2,056	$121.6	19.0%	1,349	$57.1	18.8%
$500,000 to $1,000,000.....	494	$36.3	10.9%	443	$90.1	14.0%	176	$17.7	5.8%
$1,000,000 and over.....	268	$195.8	58.8%	273	$358.3	55.8%	90	$57.7	19.1%
Total, All Taxpayers.....	**21,076**	**$332.8**	**100.0%**	**16,190**	**$641.5**	**100.0%**	**22,731**	**$303.0**	**100.0%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.
(2) Schedule E income includes income from rental real estate, royalties, partnerships, S corporations, estates and trusts, REMICS, etc.
(3) Schedule C income is income from sole proprietorships.

Table 17, below, shows the distribution of the standard deduction and total itemized deductions. It further shows the distribution of the charitable contributions deduction and the home mortgage interest deduction. The standard deduction is concentrated in lower income groups, while itemized deductions are concentrated in middle and upper income groups. The mortgage interest deduction and the charitable contributions deduction are concentrated in the

middle and upper income groups, with a particular concentration of the charitable contributions deduction in the top income group.

TABLE 17.–A DISTRIBUTION OF SELECTED DEDUCTIONS AND CREDITS

Calendar Year 2013

INCOME CATEGORY (1)	STANDARD DEDUCTION			ITEMIZED DEDUCTION (2)			SELECTED ITEMIZED DEDUCTIONS: CHARITABLE CONTRIBUTIONS			SELECTED ITEMIZED DEDUCTIONS: HOME MORTGAGE INTEREST EXPENSE		
	Returns	Dollars	Percent	Returns	Dollars	Percent	Returns	Dollars	Percent	Returns	Dollars	Percent
Less than $10,000	18,262	$127.1	12.8%	397	$6.1	0.5%	159	$0.1	0.1%	251	$2.6	0.7%
$10,000 to $20,000	17,651	$132.9	13.4%	847	$12.0	1.0%	440	$0.6	0.3%	534	$4.8	1.3%
$20,000 to $30,000	19,029	$146.2	14.8%	1,502	$22.7	1.9%	874	$1.4	0.8%	922	$8.1	2.2%
$30,000 to $40,000	13,725	$112.2	11.3%	2,427	$36.5	3.0%	1,544	$2.6	1.4%	1,566	$12.3	3.4%
$40,000 to $50,000	11,352	$98.8	10.0%	3,342	$50.7	4.2%	2,347	$4.3	2.4%	2,260	$16.5	4.5%
$50,000 to $75,000	16,295	$166.2	16.8%	8,114	$140.0	11.5%	6,252	$13.8	7.6%	5,933	$47.2	12.9%
$75,000 to $100,000	9,292	$108.7	11.0%	7,501	$148.2	12.2%	6,194	$16.5	9.2%	5,900	$51.6	14.1%
$100,000 to $200,000	7,438	$90.7	9.2%	16,446	$395.8	32.5%	14,567	$49.0	27.2%	13,923	$141.8	38.9%
$200,000 to $500,000	482	$5.9	0.6%	5,341	$219.7	18.0%	4,969	$31.9	17.7%	4,288	$63.8	17.5%
$500,000 to $1,000,000	53	$0.6	0.1%	649	$55.1	4.5%	617	$10.9	6.1%	462	$10.5	2.9%
$1,000,000 and over	27	$0.3	0.0%	321	$131.9	10.8%	310	$49.2	27.3%	203	$5.7	1.6%
Total, All Taxpayers	**113,606**	**$989.7**	**100.0%**	**46,888**	**$1,218.7**	**100.0%**	**38,274**	**$180.3**	**100.0%**	**36,241**	**$365.0**	**100.0%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.
(2) The total amount of itemized deductions are reduced by the overall limitation on itemized deductions ("Pease").
(3) Returns less than 500.
(4) Dollars less than $50,000.
(5) Percent less than 0.005%

Table 18, below, shows the distribution of the itemized deduction for state and local taxes, medical expenses, and the earned income and child credits. The medical expense deduction is concentrated in the middle of the income distribution. The earned income credit is concentrated in the lower income groups as a result of the credit's greatest value occurring at low income levels coupled with the credit's income based phaseout. The child credit is fairly evenly distributed across the lower and middle income groups as a result of the fixed dollar value per child and the fact that the phaseout of the child credit occurs further up the income distribution than does the earned income credit.

TABLE 18.–A DISTRIBUTION OF SELECTED DEDUCTIONS AND CREDITS

Calendar Year 2013

INCOME CATEGORY (1)	SELECTED ITEMIZED DEDUCTIONS: STATE AND LOCAL TAXES			SELECTED ITEMIZED DEDUCTIONS: MEDICAL EXPENSES			SELECTED CREDITS: EARNED INCOME CREDIT			SELECTED CREDITS: CHILD CREDIT		
	Returns	Dollars	Percent	Returns	Dollars	Percent		Dollars	Percent		Dollars	Percent
Less than $10,000	381	$1.3	0.3%	219	$1.6	1.5%	5,472	$7.0	10.5%	2,221	$1.2	2.2%
$10,000 to $20,000	822	$2.5	0.5%	398	$2.7	2.6%	8,273	$21.8	32.5%	5,313	$6.2	11.2%
$20,000 to $30,000	1,440	$4.5	1.0%	664	$5.4	5.1%	5,140	$16.7	24.9%	4,673	$6.9	12.3%
$30,000 to $40,000	2,352	$7.9	1.7%	1,060	$8.8	8.4%	4,040	$11.2	16.7%	4,075	$6.7	12.1%
$40,000 to $50,000	3,274	$11.9	2.5%	1,317	$11.4	10.9%	2,807	$5.9	8.8%	3,302	$5.7	10.2%
$50,000 to $75,000	8,013	$36.9	7.9%	2,593	$25.0	23.9%	2,485	$4.1	6.2%	6,039	$10.6	19.1%
$75,000 to $100,000	7,471	$44.9	9.6%	2,002	$19.5	18.6%	189	$0.3	0.4%	4,638	$8.1	14.6%
$100,000 to $200,000	16,416	$148.2	31.6%	2,174	$24.3	23.2%	8	(4)	(5)	6,472	$10.1	18.2%
$200,000 to $500,000	5,330	$102.9	21.9%	226	$5.4	5.2%	(3)	(4)	(5)	29	(4)	(5)
$500,000 to $1,000,000	647	$32.7	7.0%	8	$0.6	0.6%	(3)	(4)	(5)	(3)	(4)	(5)
$1,000,000 and over	320	$76.0	16.2%	1	$0.2	0.2%	(3)	(4)	(5)	(3)	(4)	(5)
Total, All Taxpayers	**46,465**	**$469.7**	**100.0%**	**10,660**	**$104.8**	**100.0%**	**28,415**	**$66.9**	**100.0%**	**36,761**	**$55.5**	**100.0%**

Source: Joint Committee on Taxation

Returns are in thousands; Dollars are in billions.
Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.
(2) The total amount of itemized deductions are reduced by the overall limitation on itemized deductions ("Pease").
(3) Returns less than 500.
(4) Dollars less than $50,000.
(5) Percent less than 0.005%

G. Present Law: U.S. International Taxation

1. General overview

International Tax Principles

International law recognizes the right of each sovereign nation to regulate conduct based on a nexus of the conduct to the territory of the nation or to a person (whether natural or juridical) whose status links the person to the nation, subject to limitations based on evaluating the reasonableness of the regulatory action.[724] In turn, these two broad bases of jurisdiction, *i.e.,* territoriality and nationality of the person whose conduct is regulated, have been refined and, in varying combinations, form the bases of most systems of income taxation. A number of commonly accepted principles have developed to minimize the extent to which conflicts arise as a result of extraterritorial or overlapping exercise of taxing authority. In addition to general acceptance of some variation of territorial or national nexus as a basis for taxing jurisdiction, most systems also comport with international norms by respecting reasonableness as a limit on extraterritorial enforcement, providing an enforcement mechanism such as withholding tax at source of a payment, and establishing guidelines for determining how to resolve duplicative assertions of authority.[725]

Exercise of taxing authority based on a person's status as a national, resident, or domiciliary of a jurisdiction reaches worldwide activities of such persons and is the broadest assertion of taxing authority. A more limited exercise of taxation occurs when taxation is imposed only to the extent that activities occur or property is located in the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting limited basis of taxation is a territorial application. Whether the broader or narrower basis of taxation is used by a jurisdiction, identification of the tax base depends upon establishing rules for determining the source of income and its proper allocation among related parties, as well as the status of all persons, *i.e.,* their residency for tax purposes.

The same income may be subject to taxation in two jurisdictions if those jurisdictions adopt different standards for determining residency of persons, source of income, or other basis for taxation. To the extent that the rules of two or more countries overlap, rules to mitigate potential double taxation generally apply, either by operation of bilateral treaties to avoid double taxation or in the form of legislative relief, such as credits for taxes paid to another jurisdiction.

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[724] Restatement (Third) of Foreign Relations Law of the United States, secs. 402 and 403, (1987).

[725] American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation, Proposals on U.S. Taxation of Foreign Persons and of the Foreign Income of U.S. Persons,* 4-8 (1987).

International Principles as Applied in the U.S. System

The United States has adopted a Code that combines the worldwide taxation of all U.S. persons (U.S. citizens or resident aliens and domestic corporations)[726] on all income, whether derived in the United States or abroad, with territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities, and limited deferral for foreign income earned by subsidiaries of U.S. companies. This combination is sometimes described as the U.S. hybrid system. Under this system, the application of the Code to outbound investment (the foreign activities of U.S. persons) differs somewhat from its rules applicable to inbound investment (foreign persons with investment in U.S. assets or activities).

With respect to outbound activities, income earned directly by a U.S. person, including as a result of a domestic corporation's conduct of a foreign business itself (by means of direct sales, licensing or branch operations in the foreign jurisdiction) rather than through a separate foreign legal entity, or through a pass-through entity such as a partnership, is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This taxpayer-favorable result is circumscribed by the anti-deferral rules of subpart F of the Code, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries.

By contrast, nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability, and the mechanism by which it is taxed (either by gross-basis withholding or on a net basis through tax return filing).

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used. These and other source rules are described in more detail below.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid. As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source, source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. In addition to the statutory relief afforded by the credit, the network of bilateral treaties provides a system for removing double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

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[726] Sec. 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. Instead, the expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation. This limitation is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories, commonly referred to as the "general basket" and the "passive basket." Consequently, the expense allocation rules primarily affect taxpayers that may not be able to fully use their foreign tax credits because of the foreign tax credit limitation.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions or aggressive intercompany pricing practices with respect to intangible property.

Principles Common to Inbound and Outbound Taxation

Although the U.S. tax rules often differ depending upon whether the activity in question is inbound or outbound, there are certain concepts that are equally applicable to both inbound and outbound investment. Two such areas are the transfer pricing rules and the rules for determination of source.

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[727] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

[727] 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.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[728] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[729] The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[730]

Source of income rules

Rules for determining the source of certain types of income are specified in the Code, as described briefly below. The various factors relied upon to determine the source of income for U.S. tax purposes include the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the situs of the assets that generate the income. To the extent that the source of income is not specified in the statute, the Secretary may promulgate regulations that explain the appropriate treatment. Many items of income are not explicitly addressed by either the Code or Treasury regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[731]

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[732] Special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or

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[728] 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."

[729] 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 tax purposes that exceeds its customs value.

[730] H.R. Rep. No. 99-426, p. 423.

[731] See, *e.g.*, *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[732] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

partnerships and certain other amounts paid by foreign branches of domestic financial institutions.[733] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[734]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[735] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[736]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[737] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[738] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[739] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[740] while the term "U.S. resident" comprises any juridical entity which is a U.S.

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[733] Sec. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations, the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution, resulting in treating the payment as a withholdable payment. Sec. 1473(1)(C).

[734] Sec. 884(f)(1).

[735] Secs. 861(a)(2), 862(a)(2).

[736] Sec. 861(a)(2)(B).

[737] Sec. 861(a)(4).

[738] *Ibid.*

[739] Sec. 865(a).

[740] Sec. 865(g)(1)(B).

person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a foreign country or a nonresident alien with a tax home in the United States.[741] As a result, nonresident includes any foreign corporation.[742]

Under several exceptions to the general rule, income from sales of property by nonresidents may be treated as U.S.-source income. For example, gain of a nonresident on the sale of inventory property may be treated as U.S.-source income if title to the property passes in the United States or if the sale is attributable to an office or other fixed place of business maintained by the nonresident in the United States.[743] If the inventory property is manufactured in the United States by the person that sells the property, a portion of the income from the sale of such property in all events is treated as U.S.-source income.[744] Gain of a nonresident on the sale of depreciable property is treated as U.S.-source income to the extent of prior U.S. depreciation deductions.[745] 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.[746]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.[747] Compensation for services performed both within and without the United States is allocated between U.S. and foreign source.[748]

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[741] Sec. 865(g)(1)(A).

[742] Sec. 865(g).

[743] Secs. 865(b) and (e), 861(a)(6).

[744] Sec. 863(b).

[745] Sec. 865(c).

[746] Sec. 865(d).

[747] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[748] Treas. Reg. sec. 1.861-4(b).

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[749]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[750] Fifty percent of other income attributable to transportation which begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income.[751] The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.[752]

Amounts received with respect to guarantees of indebtedness

Amounts received 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, whether received directly or indirectly.[753] This includes payments that are made indirectly for the provision of a guarantee. For example, income from U.S. sources includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made

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[749] Sec. 861(a)(7).

[750] Sec. 863(c).

[751] Sec. 863(d).

[752] Sec. 863(e).

[753] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *aff'd* 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). The Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S. source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

2. U.S. tax rules applicable to U.S. activities of non-U.S. persons (inbound)

The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") or income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code or a bilateral income tax treaty. The rules for U.S.-source FDAP and for ECI are discussed in more depth below.

Branch taxes, described below, are intended to provide rough equality in the taxation of branch and subsidiary operations in the United States. Also described below are special rules for the taxation of foreign persons' sales and other dispositions of U.S. real estate and for the treatment of interest on related-party indebtedness.

Gross-Basis Taxation of U.S.-Source Income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

Types of income subject to gross-basis taxation

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.[754] The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved

[754] Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates.

in determining the seller's basis and resulting gain from sales of property.[755] The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.[756]

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.[757] Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more[758] that are treated as U.S.-source are subject to gross-basis taxation.[759] In contrast, U.S-source gains from the sale or exchange of intangibles are subject to tax, and subject to withholding if they are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business.[760]

Withholding on FDAP payments to foreign payees is required unless the withholding agent,[761] *i.e.,* the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[762] The principal statutory

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[755] *Commissioner v. Wodehouse,* 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, *i.e.,* subject to withholding, in response to "a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936)." In doing so, the Court rejected P.G. Wodehouse's arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.

[756] *Commissioner v. Wodehouse,* 337 U.S. 369, 393 (1949).

[757] Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2).

[758] 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).

[759] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980.

[760] Secs. 871(a)(1)(D), 881(a)(4).

[761] Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[762] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b).

exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest.[763]

Interest on bank deposits

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S. source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[764] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[765] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[766] Additionally, there is generally no information reporting required with respect to payments of such amounts.[767]

Portfolio interest

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from 30 percent withholding.[768] For obligations issued before March 19, 2012, the term "portfolio interest" means 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, as well as interest paid on an obligation that is not in registered form provided the obligation is shown to be targeted to foreign investors under the conditions

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[763] A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

[764] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[765] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[766] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[767] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS and the Treasury Department recently proposed regulations that would expand the required annual reporting to include U.S. bank deposit interest paid to any nonresident alien. Prop. Treas. Reg. sec. 1.6049-4, 76 Fed. Reg. 1105 (Jan. 7, 2011). The proposed regulation is similar to an earlier, short-lived proposal. See 66 Fed. Reg. 3925 (Jan. 17, 2001), withdrawn at 67 Fed. Reg. 50,386 (Aug. 2, 2002).

[768] Secs. 871(h), 881(c). In 1984, to facilitate access to the global market for U.S. dollar-denominated debt obligations, Congress repealed the withholding tax on portfolio interest paid on debt obligations issued by U.S. persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

sufficient to establish deductibility of the payment of such interest.[769] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[770] certain contingent interest,[771] interest received by a controlled foreign corporation from a related person,[772] 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.[773]

Reduced and zero rates of withholding under tax treaties

The 30-percent withholding tax on FDAP income is reduced or eliminated under bilateral income tax treaties that cover a large portion of that income. Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties. The United States, however, has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model Treaty"). Under the U.S. Model Treaty, the withholding tax rate on royalties and interest is zero percent and on dividends is five percent (if the taxpayer owns at least 10 percent of the voting stock of the company) or 15 percent (if the taxpayer owns less than 10 percent).

Imposition of gross-basis tax and reporting by U.S. withholding agents

The 30-percent tax on FDAP income is generally collected by means of withholding.[774] In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient's liability. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient.

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source

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[769] Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See, Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

[770] Sec. 871(h)(3).

[771] Sec. 871(h)(4).

[772] Sec. 881(c)(3)(C).

[773] Sec. 881(c)(3)(A).

[774] Secs. 1441, 1442.

income that is subject to reporting.[775] The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[776] Withheld tax is credited to the recipient of the income,[777] and to the extent that the withheld amount results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

The U.S. withholding tax rules are administered through a system of self-certification. A nonresident investor seeking to obtain withholding tax relief for U.S.-source investment income must certify to the withholding agent, under penalty of perjury, the person's foreign status and eligibility for an exemption or reduced rate. This self-certification is made on the relevant IRS form, similar to those used by U.S. persons to establish an exemption from the rules governing information reporting on IRS Form 1099 and backup withholding.[778]

The United States imposes tax on the beneficial owner of income, not its formal recipient. To avoid cascading imposition of the withholding tax as payments move through intermediaries to the beneficial owner, the regulations outline the specific rules relating to situations whereby an intermediary may take on the responsibility to withhold and the withholding agent may rely upon the intermediary to do so.[779]

Foreign Account Tax Compliance Act ("FATCA")

A separate reporting and withholding regime for outbound payments addresses compliance of U.S. persons.[780] Commonly referred to as the Foreign Account Tax Compliance Act,[781] the new regime imposes a withholding tax of 30 percent of the gross amount of certain payments to foreign financial institutions ("FFIs") unless the FFI establishes that it is compliant with FATCA. The information reporting requires identification by third parties of certain U.S. accounts held in an FFI. An FFI must report with respect to a U.S. account (1) the name, address, and taxpayer identification number of each U.S. person holding an account or a foreign entity with one or more substantial U.S. owners holding an account, (2) the account number, (3) the account balance or value, and (4) except as provided by the Secretary, the gross receipts and gross withdrawals or payments from the account.[782]

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[775] Treas. Reg. sec. 1.1461-1(b), (c).

[776] See Treas. Reg. secs. 1.1441-7(a) (definition of withholding agent includes foreign persons).

[777] Sec. 1462.

[778] See Treas. Reg. sec. 1.1441-1(b)(5).

[779] Treas. Reg. sec. 1.1441-1(b)(1)

[780] Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147.

[781] Foreign Account Tax Compliance Act of 2009 is the name of the House and Senate bills in which the provisions first appeared. See H.R. 3933 and S. 1934 (October 27, 2009).

[782] Sec. 1471(c).

Final regulations published in 2013 provide guidance on how FFIs may comply with FATCA. An FFI may become a participating FFI by entering into and complying with an information reporting agreement with the Secretary of the Treasury. A non-participating FFI may nonetheless establish its FATCA compliance through a registration process, under which it will be deemed to be in compliance. A list of FATCA compliant institutions is to be available electronically from the IRS. The list can be relied upon by withholding agents in determining the status of a payee. To be included on the list, an FFI applies to the IRS for issuance of a Global Intermediary Identification Number (GIIN). If approved, the applicant and GIIN will be included in the published list. The registration process and access to the list is electronic.

The process for complying with FATCA is expected to be further streamlined for FFIs resident in jurisdictions that are parties to an intergovernmental agreement ("IGA") with the United States.[783] In 2012, the United States began negotiations for a series of bilateral IGAs,[784] on the authority of its various tax treaties and agreements to exchange information, with the intention of forming a partnership with another jurisdiction (FATCA partner) to facilitate the implementation of FATCA and obviate any legal impediments that FFIs that are resident in a FATCA partner may otherwise have faced in complying with the terms of FATCA. The United States has signed intergovernmental agreements with Switzerland, United Kingdom, Ireland, Denmark and Mexico. In addition, it has completed negotiations with Spain, Chile and Italy.

All bilateral IGAs conform to models published in 2012.[785] The Model 1 bilateral agreement provides a framework in which an FFI provides information to the tax authorities of the FATCA partner rather than to the IRS. The FATCA partner then provides information to the United States under an automatic exchange of information. In a variation on Model 1 referred to as the reciprocal version, the agreements include a reciprocal commitment for automatic exchange of information, under which the United States agrees to provide automatic exchange of certain information identified in the IGA and collected under U.S. information reporting requirements with respect to residents of the FATCA partner. Model 2 creates a framework under which the FATCA partner agrees to waive domestic restrictions that would prevent FFIs from reporting directly to the IRS. The FATCA partner also agrees to honor U.S. requests for requests for exchange of information as needed. The FFIs provide the requisite information directly to the IRS.

Third-party reporting is not the only means by which compliance of U.S. persons with foreign financial holdings is encouraged. Reporting by taxpayers about their foreign holdings

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[783] Although the information reporting requirement under Chapter 4 were initially to go into effect with respect to payments made after December 31, 2012, several aspects of the implementation have been delayed. In Announcement 2012-42, the IRS published an implementation timeline for due diligence requirements that were later included in the final regulations published January 28, 2013. T.D. 9610, Treas. Reg. sec. 1.1471-1 through 1.1474-7.

[784] Joint Statement with France, Germany, Italy, Spain, and the United Kingdom, February 2, 2012, available at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx

[785] Model agreements as well as signed IGAs are available at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

was also enacted contemporaneously with FATCA. Effective for tax years beginning after the date of enactment (March 18, 2010), individuals are required to disclose with their annual Federal income tax return any interest in foreign accounts and certain foreign securities if the aggregate value of such assets is in excess of the greater of $50,000 or an amount determined by the Secretary in regulations. Failure to do so is punishable by a penalty of $10,000, which may increase for each 30 day period during which the failure continues after notification by the IRS, up to a maximum penalty of $50,000.[786] In addition, U.S. persons with foreign holdings may be required to file an annual form TD F 90-22.1, Foreign Bank Account Report ("FBAR"). The FBAR includes information about foreign financial accounts held or controlled, as provided under regulations implementing the Bank Secrecy Act.[787]

Net-Basis Taxation

Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States.[788] 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.[789]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.[790]

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

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[786] Sec. 6038D. On February 12, 2012, temporary regulations were published, effective on December 19, 2011, providing guidance on the scope of reporting required, the threshold values triggering reporting requirements for various fact patterns and how the value of assets is to be determined. T.D. 9567, Treas. Reg. secs. 1.6038D-1T to 1.6038D-8T.

[787] 31 U.S.C. sec. 5311 et seq.; 31 C.F.R. Chapter X.

[788] Secs. 871(b), 882.

[789] Secs. 871(b)(2), 882(a)(2).

[790] Sec. 875.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[791] 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.[792] Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[793] 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. 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 ("ECI")

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.[794]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[795] Under the asset use and business activities tests, due regard is given to whether the income, gain,

[791] Sec. 864(b).

[792] Sec. 864(b)(1).

[793] Sec. 864(b)(2).

[794] Sec. 864(c).

[795] Sec. 864(c)(2).

or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.[796]

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[797] Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person's foreign-source income generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or 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.[798] 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.[799]

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.[800] 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.[801]

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[796] Sec. 864(c)(3).

[797] This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.

[798] Sec. 864(c)(4)(B).

[799] Sec. 864(c)(4)(D)(i).

[800] Sec. 864(c)(5)(A).

[801] Sec. 864(c)(5)(B).

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.[802]

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[803] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[804] 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 determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.[805]

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

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[802] Sec. 864(c)(4)(C).

[803] Sec. 864(c)(1)(B).

[804] Sec. 864(c)(6).

[805] Sec. 864(c)(7).

Special Rules[806]

Branch taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. withholding tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.[807]

The United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."[808] The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.[809] Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.[810]

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (that is, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[811] 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.

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[806] For legislative background to the rules described below, see Joint Committee on Taxation, *Present Law and Background Related to U.S. Activities of Foreign Persons* (JCX-37-11), June 22, 2011, pp. 30, 34-39.

[807] See Treas. Reg. sec. 1.884-1(g), -5.

[808] Sec. 884(a).

[809] Sec. 884(b).

[810] See sec. 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of U.S. real property interests described in section 897 (discussed below)).

[811] Sec. 884(b).

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).[812] Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.[813] 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.

Foreign Investment in Real Property Tax Act of 1980

A foreign person that is not engaged in business in the United States (and is not an individual who is present in the United States at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources.[814]

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[815] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.[816] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[817] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

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[812] Sec. 884(f)(1)(A).

[813] Sec. 884(f)(1)(B).

[814] Secs. 871(b), 882(a).

[815] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

[816] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[817] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that reduces the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and interests (other than any interest solely as a creditor) in a domestic U.S. real property holding corporation ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during the shorter of the taxpayer's ownership of the stock or the five-year period ending on the date of disposition of the stock.[818] However, any class of stock that is regularly traded on an established securities market is treated as a USRPI only if the seller held more than five percent of the stock at any time during such period.[819]

Under these rules, for example, if a foreign person directly owns U.S. real estate, or owns U.S. real estate through a partnership, gain from the sale of the real estate is subject to tax as FIRPTA income. Alternatively, if a foreign person owns U.S. real estate through a corporation that is a USRPHC that is not publicly traded (or owns more than five percent of the stock of a publicly traded USRPHC during the relevant period), gain from sale of the corporate stock is generally subject to tax as FIRPTA income.

Special rules apply to real estate investment trusts ("REITs") and to regulated investment companies ("RICs" or mutual funds) that predominantly own USRPIs.[820]

Earnings stripping

Foreign corporations are limited in their ability to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through certain earnings stripping transactions involving interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's "excess interest expense."[821] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[822] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by

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[818] Secs. 897(c)(1)(A)(ii), 897(c)(2).

[819] Sec. 897(c)(3). Constructive ownership rules apply under section 897(c)(6)(C).

[820] Sec. 897(h). REITs and these RICs are referred to in section 897(h) as "qualified investment entities." The IRS has issued guidance clarifying that tax under FIRPTA applies when a foreign government receives a distribution from a qualified investment entity that is attributable to the entity's gain from the sale of USRPIs. Notice 2007-55, 2007-2 C.B. 13 (July 2, 2007).

[821] Sec. 163(j).

[822] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

which the payor's "net interest expense" (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

3. U.S. tax rules applicable to foreign activities of U.S. persons (outbound)

In General

The United States has a worldwide tax system under which U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[823] and the passive foreign investment company rules.[824] 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.[825]

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 or included in the domestic corporation's income under the anti-deferral rules.[826]

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[823] Secs. 951-964.

[824] Secs. 1291-1298.

[825] Secs. 901, 902, 960, 1291(g).

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

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.[827] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[828]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each category by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category (described below), on the other.[829] In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[830] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[831] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[832]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[833] These rules exclude foreign corporations from an affiliated group.[834] For taxable years beginning after December 31, 2020, the interest allocation rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic

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[827] Secs. 901, 904.

[828] Sec. 904(c).

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

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

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

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

[833] Secs. 864(e)(5), 1504.

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

and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to "passive category income" and to "general category income."[835] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a controlled foreign corporation are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[836] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a controlled foreign corporation are also categorized on a look-through basis.[837]

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

Anti-Deferral Regimes

In general

Income earned indirectly by a domestic corporation through a foreign subsidiary corporation is generally subject to U.S. tax only when the income is distributed to the domestic parent corporation because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that

[835] Sec. 904(d). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, for example, secs. 865(h), 901(j), 904(d)(6), and 904(h)(10).

[836] Sec. 904(d)(3). The subpart F rules applicable to controlled foreign corporations and their 10-percent U.S. shareholders are described below.

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

impose current U.S. tax on certain types of income earned by certain corporations. These anti-deferral rules are intended to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is permitted for most types of active business income derived abroad.

Subpart F

Generally

Subpart F,[838] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation ("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 own at least 10 percent of the stock (measured by vote only).[839] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[840]

With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[841] insurance income,[842] and certain income relating to international boycotts and other violations of public policy.[843] Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution out of the corporation's subpart F income.

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[844] This U.S. property generally includes tangible property

[838] Secs. 951-964.

[839] Secs. 951(b), 957, 958.

[840] Sec. 951(a).

[841] Sec. 954.

[842] Sec. 953.

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

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

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.[845] 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.[846] 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.

Exceptions: CFC look-through and active financing income

A temporary provision (colloquially referred to as the "CFC look-through" rule) excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[847]

Another temporary provision excludes from subpart F income certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[848]

Income is treated as active financing only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. Certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.[849] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC the home country of which is the same as the home country of the related CFC or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized.[850] These exclusions do not apply to the extent the payments reduce the subpart F

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

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

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

[848] Sec. 954(h).

[849] Code sec. 954(h)(3)(E).

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

income of the payor. There is an exception from foreign base company income and insurance income for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[851]

Passive foreign investment companies

A U.S. person who is a shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax in respect of that person's share of the PFIC's income under one of three alternative anti-deferral regimes. A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[852] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[853] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[854] 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."[855]

Other anti-deferral 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[856] and the personal holding company rules.[857] Until their repeal in 2004, two

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

[852] Sec. 1297.

[853] Secs. 1293-1295.

[854] Sec. 1291.

[855] Sec. 1296.

[856] Secs. 531-537.

[857] Secs. 541-547. The accumulated earnings tax rules and the personal holding company rules apply in respect of both U.S.-source and foreign-source income.

other sets of anti-deferral rules, those applicable to foreign personal holding companies and those for foreign investment companies, applied to foreign operations of U.S. companies.[858]

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

Special Rules For U.S. Citizens Living Abroad: The Foreign Earned Income Exclusion

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on that income by the foreign country. As a practical matter, the United States generally cedes the primary right to tax a U.S. citizen's foreign source income to the foreign country in which the income is derived.[859] This concession is effected by the allowance of a credit against the U.S. income tax imposed on foreign-source income for foreign taxes paid on that income. As described previously, the amount of the credit for foreign income tax paid on foreign-source income generally is limited to the amount of U.S. tax otherwise owed on that income. Accordingly, if the amount of foreign tax paid on foreign-source income is less than the amount of U.S. tax owed on that income, a foreign tax credit generally is allowed in an amount not exceeding the amount of the foreign tax, and a residual U.S. tax liability remains.

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.[860] This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a "qualified individual") must have his or her tax home in a foreign country and must be either (1) a U.S. citizen[861] who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period.

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[858] Secs. 551-558, 1246-1247.

[859] In a provision referred to as the "saving clause," the United States reserves the right to tax its citizens as citizens under bilateral income tax treaties.

[860] Sec. 911.

[861] Generally, only U.S. citizens may qualify under the bona fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, qualify for the section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision of the treaty.

The maximum amount of foreign earned income that an individual may exclude in 2013 is $97,600.[862] The maximum amount of foreign housing costs that an individual may exclude in 2013 is, in the absence of Treasury adjustment for geographic differences in housing costs, $13,664.[863] The combined foreign earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

4. U.S. tax rules applicable to the U.S. territories

Background

The United States has 13 territories under the jurisdiction of the Department of the Interior.[864] Three of the territories, Navassa Island, Puerto Rico, and the U.S. Virgin Islands, are in the Caribbean Sea. Ten territories – American Samoa, Baker Island, Guam, Howland Island, Jarvis Island, Johnston Atoll, Kingman Reef, Midway Atoll, the Northern Mariana Islands, and Wake Atoll – are in the Pacific Ocean. Two territories, the Northern Mariana Islands (also referred to as "Northern Marianas") and Puerto Rico, are commonwealths. Commonwealth status typically involves a legal relationship with the United States that is embodied in a written mutual agreement. Territories that do not have commonwealth status generally have less developed legal relationships with the United States. Their governments are generally constituted by U.S. Federal statutes referred to as organic acts.

The summary below describes U.S. Federal tax rules and issues related to the five territories that have significant populations: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. American Samoa became a U.S. territory by deed of cession from the local chiefs of the largest island in 1900. It has no organic act for the establishment of its government, but it adopted its own constitution in 1967. Guam became a territory in 1898, and its organic act was enacted in 1950. For the Northern Mariana Islands a covenant to establish political union with the United States signed in 1975 and came into full effect in 1986. Puerto Rico became a territory in 1898 and a commonwealth 1952. The United States purchased the U.S. Virgin Islands from Denmark in 1917, and the Virgin Islands' current organic act was enacted in 1954. The five territories are represented in the U.S. Congress by non-voting delegates (in the case of Puerto Rico, a non-voting resident commissioner) in the House of Representatives. Residents of Guam, the Northern Mariana Islands, Puerto Rico, and

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[862] Sec. 911(b)(2)(D)(i). This amount is adjusted annually for inflation. For the 2013 amount, see Rev. Proc. 2012- 41, 2012-2 C.B. 539 (Oct. 18, 2012), section 3.17. The exclusion amount is taken against the lowest marginal tax rates. See sec. 911(f).

[863] Sec. 911(c)(1), (2). The Treasury Secretary has authority to issue guidance making geographic cost-based adjustments. Sec. 911(c)(2)(B). The Secretary has exercised this authority annually. The most recent guidance, Notice 2013-31, 2013 I.R.B. LEXIS 253 (May 1, 2013), includes adjustments for many locations. Under these adjustments, the maximum housing cost exclusion for any geographic area is $101,484 for expenses for housing in Tokyo, Japan.

[864] The source of information about the territories included in this paragraph and the paragraph that follows is the website of the Office of Insular Affairs of the Department of the Interior: http://www.doi.gov/oia/index.html.

the U.S. Virgin Islands are generally U.S. citizens. American Samoa residents, by contrast, are generally nationals but not citizens.

Following common current and historical tax law usage, the summary below uses the term "possessions" interchangeably with "territories."

In General

While U.S. statutory laws apply to the U.S. possessions, and natives of U.S. possessions are U.S. citizens or nationals, for tax purposes the Code generally treats the U.S. possessions as foreign countries. When the Code uses the term in a geographical sense, the "United States" includes only the 50 States and the District of Columbia.[865]

The meaning of the term possession is not uniform throughout the Code, and is not among the defined terms in section 7701. For purposes of assessment and collection of Federal taxes, the possessions are generally treated the same as the States, except as provided in the Revised Organic Act of the Virgin Islands and the Organic Act of Guam with respect to certain taxes covered over to the treasuries of the U.S. Virgin Islands and Guam.[866] Taxes imposed by the Code in any possession are collected under the direction of the Secretary. Taxes with respect to any individual to whom section 931 or 932(c) applies are covered into the Treasury of the specific possession of which the individual is a bona fide resident.[867]

Income derived from U.S. possessions is ordinarily treated as foreign-source income. Entities organized in U.S. possessions are generally treated as foreign persons. Of the various trust territories and possessions of the United States, only those with local taxing authorities that have entered into a tax coordination agreement with the United States, that is, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands, are provided special treatment in the Code and are the focus of this pamphlet.[868]

Three of the possessions employ a "mirror system" of taxation. In Guam,[869] the Commonwealth of Northern Mariana Islands[870] and the U.S. Virgin Islands,[871] the United States

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[865] Sec. 7701(a)(9).

[866] Sec. 7651.

[867] Sec. 7654.

[868] See Rev. Proc. 2006-23, 2007-1 C.B. 900. In addition to these five jurisdictions, other territories may be considered possessions of the United States for political purposes but are not generally accorded special status under the Code or by Treasury. But see, *e.g.*, section 274(h)(3)(A) (defines "North American area" to include the United States, its possessions and the Trust Territory of the Pacific Islands, as well as Canada and Mexico) and Rev. Rul. 2011-26, 2011-1 C.B. 803 (explains the current status of the entities that were part of the Trust Territory when 274(h) was enacted, and rules that "possessions" includes, in addition to the five discussed in this pamphlet, Baker Island, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, the Midway Islands, Palmyra Atoll, Wake Island, and any other United States islands, cays, and reefs that are not part of the fifty states or the District of Columbia).

[869] The 1950 Organic Act of Guam, 48 U.S.C. sec. 1421i(h) (2012).

Federal income tax laws are in effect (or "mirrored") as the local territorial income tax. Proceeds of the mirror codes are generally paid to the treasuries of the possessions. Not all of the Code is mirrored; generally, only the income tax provisions of the Code are mirrored.[872] In the tax statutes as in effect in each of these possessions, the name of the possession is substituted for "United States," and vice-versa. Although the reverse substitution is not explicitly described in any of the operative statutes for the possessions, two-way mirroring has been required to give effect to the intent of the mirroring requirement. To the extent that mirroring would produce a result manifestly incompatible with the Code or other provisions of the United States Code, mirroring is not required.[873]

The Tax Reform Act of 1986 (the "1986 Act") granted authority to Guam, the Commonwealth of Northern Mariana Islands and American Samoa to cease use of the mirror system, and authorized the U.S. Virgin Islands to impose local taxes at variance from the rates in the Code as mirrored. It repealed the relevant rules that provide coordination between the Federal statutes and the statutes as mirrored in Guam, American Samoa and the Northern Mariana Islands and amended the coordination rules for the U.S. Virgin Islands. The changes are not yet in effect for Guam or the Northern Mariana Islands, because the effective date is contingent upon the existence of an implementation agreement, and the contingency has not been met.[874]

Income Taxation of Individuals

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. Thus, all income earned by a U.S. citizen or resident, whether from

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[870] Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States of America ("Covenant"), Act of March 24, 1976, Pub. L. No. 94-241, 48 U.S.C. sec. 1801 (note) (2012); President Ronald Reagan, "Placing Into Full Force and Effect the Covenant With the Commonwealth of the Northern Mariana Islands, and the Compacts of Free Association With the Federated States of Micronesia and the Republic of the Marshall Islands," Proclamation No. 5564, 51 Fed. Reg. 40,399-400 (Nov. 3, 1986).

[871] Act July 12, 1921, ch 44, 42 Stat. 123, popularly known as the Naval Service Appropriation Act, 1922, codified at 48 U.S.C. sec. 1397 (2012).

[872] For example, 48USC 1421i(d) specified that for Guam, the mirrored sections include most of subtitle A (income tax), chapters 24 and 25 (withholding tax), and subtitle F (administrative) as applicable to the income tax.

[873] *Gumataotao v. Director of Revenue and Taxation of Guam*, 236 F.3d 1077, 1080 (9th Cir. 2001) ("Only those provisions of the I.R.C. that are "manifestly inapplicable or incompatible with the intent of [the Income Tax Section do not apply to Guam taxpayers."); *48 U.S.C. § 1421i(d);* see *Sayre & Co. v. Riddell, 395 F.2d 407, 410 (9th Cir. 1968)* (en banc) ("Sayre") (G.T.I.T. "mirrors" the I.R.C., except where "manifestly inapplicable or incompatible")."

[874] The special effective date for the revision of section 931 and repeal of section 935 is provided in section 1277(b) of the 1986 Act, stating "The amendments made by this subtitle shall apply with respect to Guam, American Samoa, or the Northern Mariana Islands (and to residents thereof and corporations created or organized therein) only if (and so long as) an implementing agreement under section 1271 is in effect between the United States and such possession." Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1277(a), (b), 100 Stat. 2085, 2600 (1986).

sources inside or outside the United States, is taxable whether or not the individual lives within the United States. All U.S. citizens and residents whose gross income for a taxable year is not less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

The taxable income of a U.S. citizen or resident is equal to the taxpayer's total worldwide income less certain exclusions, exemptions, and deductions. A foreign tax credit, with limitations, may be claimed for foreign income taxes paid or accrued, or, alternatively, foreign taxes may be treated as a deduction. Income taxes paid in a U.S. possession are generally creditable taxes for these purposes.

Generally, special U.S. income tax rules apply with respect to U.S. persons who are bona fide residents of U.S. possessions and who have possession source income or income effectively connected with the conduct of a trade or business within a possession.[875] The term bona fide resident means a person who meets a two-part test with respect to American Samoa, Guam, the U.S. Virgin Islands, Puerto Rico, or the Northern Mariana Islands as the case may be, for the taxable year. First, an individual must be present in the U.S. possession for at least 183 days in the taxable year.[876] Second, an individual must (1) not have a tax home outside such possession during the taxable year and (2) not have a closer connection to the United States or a foreign country during such year.

Individual residents living in U.S. possessions generally are subject to either a single- or double-filing system with respect to their income. Individual residents subject to section 931 or 933 (that is, bona-fide residents of American Samoa and Puerto Rico) operate under a double-filing system. Under a double-filing system, income that is not exempt from U.S. tax under section 931 or 933, and meets certain filing thresholds, must be reported to the United States on a U.S. return. Thus, an individual operating under a double-filing system that has income from sources outside the U.S. possession where the individual is resident (*e.g.*, a Puerto Rico individual with non-Puerto Rico-source income) must file a tax return in the United States and in the U.S. possession where the individual is a bona-fide resident if such income is subject to reporting. Income reported on a U.S. return by a bona-fide resident of a U.S. possession is generally subject to the same U.S. tax treatment that applies to individuals resident in the United States.

In contrast, individual residents subject to section 932(c) or 935 (that is, bona fide residents of the U.S. Virgin Islands, as well as the Northern Mariana Islands and Guam[877])

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[875] For more detail about these special rules, see generally, Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation*, "U.S. Taxation Relating to Possessions" (Warren Gorman and Lamont-RIA, 2005), Part D.

[876] Sec. 937(a). Treasury regulations provide guidance related to meeting the presence test, including exceptions for certain extended absences from the possession. Treas. Reg. sec. 1.937-1.

[877] The repeal of section 935 is not yet effective for Guam or the Northern Marianas, due to failure to meet the condition in the special effective date provided in section 1277(b) of the 1986 Act, which states, "The amendments made by this subtitle shall apply with respect to Guam, American Samoa, or the Northern Mariana Islands (and to residents thereof and corporations created or organized therein) only if (and so long as) an

generally operate under a single-filing system. Under a single-filing system, income is only reported in one jurisdiction, based on bona-fide residency. Thus, an individual operating under a single-filing system generally does not have to file a tax return with the United States. In a single-filing system, income is often allocated between the U.S. possession and the United States through a cover over[878] mechanism.

As a general rule, the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.[879]

For purposes of the foreign earned income exclusion, the U.S. possessions are not treated as foreign countries. Thus, residents of U.S. possessions do not qualify for the foreign earned income or housing exclusion under section 911 of the Code because they are not considered resident abroad.[880]

U.S. citizens who relinquish their citizenship and U.S. residents who terminate their long-term residency may be subject to special tax rules intended to limit any tax benefits from expatriation. Certain persons expatriating before June 17, 2008 are subject to an alternative tax regime for a period of 10 years if they meet certain income and net-worth thresholds or they fail to comply with certain U.S. Federal tax obligations.[881] Certain persons expatriating after June 16, 2008, are treated as if all property was sold on the day before their expatriation date for its fair market value.[882] U.S. citizens and lawful permanent residents who leave the United States and establish residency in one of the possessions are generally not considered to have either relinquished their U.S. citizenship or terminated their U.S. residency; however, the special source rules may apply to U.S. citizens and residents that leave the United States and establish

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implementing agreement under section 1271 is in effect between the United States and such possession." Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1277(a), (b), 100 Stat. 2085, 2600 (1986).

[878] Cover over refers to the collection of certain taxes and fees by the U.S. Treasury and subsequent payment of such taxes and fees to the governments of the territories as specified.

[879] Sec. 937(b).

[880] Treas. Reg. secs. 1.911-2(g),(h).

[881] Sec. 877.

[882] Sec. 877A.

residency in American Samoa, the Northern Mariana Islands, or Guam during the 10-year period beginning when the person first becomes a resident.[883]

Income Taxation of Corporations

U.S. corporations

U.S. corporations are subject to U.S. income tax on their worldwide income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[884] and the passive foreign investment company rules.[885] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

Foreign corporations

Foreign corporations with U.S. source income are generally subject to U.S. tax on a net basis at graduated rates on income effectively connected to a U.S. trade or business. U.S.-source passive income paid to a foreign corporation is generally taxed on a gross basis at a withholding rate of 30 percent. Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. However, several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation.

Corporations formed in the U.S. possessions are generally treated as foreign corporations for U.S. tax purposes. Thus, the foreign status of entities formed in a U.S. possession means that the shareholders of such entities may be subject to U.S. anti deferral regimes, such as the controlled foreign corporation regime (subpart F), and the shareholders of such entities may have to pay current U.S. tax on their foreign source income.

However, notwithstanding the general rule that companies organized in a U.S. possession are treated as foreign corporations, certain qualifying corporations are deemed not to be foreign corporations for purposes of withholding taxes on passive income. Corporations organized in

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[883] See section 1277(e) of the 1986 Act. Under this special source rule, gains from dispositions of certain property held by a U.S. person prior to becoming a resident in American Samoa, the Northern Mariana Islands, or Guam are treated as income from sources within the United States for all purposes of the Code.

[884] Secs. 951-964.

[885] Secs. 1291-1298.

American Samoa, Guam, the U.S. Virgin Islands, or the Northern Mariana Islands are not subject to withholding tax on payments from corporations organized in the United States, provided that certain local ownership and activity requirements are met.[886] In turn, each of those possessions have adopted local internal revenue codes that provide a zero rate of withholding tax on payments made by corporations organized in such possession to corporations organized in the United States. Thus, certain corporations organized in American Samoa, Guam, the U.S. Virgin Islands, or the Northern Mariana Islands can receive dividend payments from a U.S. subsidiary at a zero rate of withholding.

Estate and Gift Taxation

U.S. citizens and residents

U.S. citizens and residents are subject to estate tax on the transfer of their worldwide estate at the time of death. The taxable estate is equal to the decedent's worldwide gross estate, less allowable deductions (including the marital deduction). Certain credits are allowed, including the unified credit, which directly reduce the amount of the estate tax.[887]

U.S. citizens and residents are subject to gift tax on transfers of property by gift made directly or indirectly, in trust or otherwise. Thus, the gift tax applies to transfers of property, regardless of where such property is situated. The amount of a taxable gift is determined by the fair market value of the property on the date of the gift. An annual exclusion (adjusted periodically for inflation)[888] applies to gifts given in a calendar year.[889]

A U.S. citizen residing in a U.S. possession is treated as a citizen for estate and gift tax purposes unless he acquired U.S. citizenship solely by reason of birth or residence within the possession.[890]

Nonresident aliens

The estate of a nonresident alien generally is taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death (and certain property transferred during life subject to reserved interests or powers). This estate generally includes the value at death of all real and personal tangible property situated in the United States and certain intangible property, such as

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[886] Sec. 881(b).

[887] The unified credit amount is the tax computed on the applicable exclusion amount or $5.25 million for 2013 (indexed for inflation). The maximum estate tax rate is 40 percent.

[888] Sec. 2503(b). The annual gift tax exclusion amount for 2013 is $14,000.

[889] An applicable exclusion amount applies for computing the gift tax on lifetime transfers ($5.25 million for 2013), and the maximum gift tax rate is 40 percent.

[890] Secs. 2208 (estate tax) and 2501(b) (gift tax).

stock of a domestic corporation, considered to be situated in the United States.[891] The estate of a nonresident alien is allowed a unified credit of $13,000[892] and under treaty may instead be allowed a pro rata portion of the generally applicable unified credit.

Nonresident alien individuals are subject to gift tax with respect to certain transfers by gift of U.S.-situated property under the same tax rate schedule applicable to U.S. citizens. The tax applies only where the value of the transfer exceeds the annual exclusion amount.[893] Such property includes real estate and tangible property located within the United States. Nonresident aliens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

A U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes if the individual's U.S. citizenship was acquired solely by reason of birth or residence within the possession.[894] Estates of decedents who are treated as nonresident aliens for purposes of this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value the decedent's gross estate situated in the United States bears to the value of the entire gross estate wherever situated.[895]

Payroll Taxes

Employees and employers in the United States are subject to payroll taxes for the Federal Insurance Contributions Act ("FICA") that fund Social Security and certain Medicare benefits, Federal unemployment insurance payroll tax ("FUTA"), and the withholding tax for Federal income tax.[896] FICA imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax as a percentage of covered wages; and (2) the Medicare hospital insurance ("HI") tax amount, also a percentage of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer. Certain categories of services and employment are often exempt from FICA, including foreign agricultural workers with appropriate visas.

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[891] For these purposes the United States means the 50 States and the District of Columbia.

[892] Sec. 2102(b). This credit essentially acts to shelter the first $60,000 of the taxable estate from Federal estate tax.

[893] The annual exclusion amount is $14,000 for 2013 (indexed for inflation).

[894] Sec. 2209 (estate tax) and 2501(c) (gift tax).

[895] Sec. 2102(b)(2).

[896] Secs. 3121(a) and 3402(a).

Similar FICA payroll tax obligations generally apply to persons in any of the U.S. possessions.[897] In contrast, employees and employers in the possessions are generally not subject to the withholding at source for Federal income tax, although they are subject to withholding for local taxes.[898] These payroll obligations of the employers are generally applicable to Federal agencies with personnel in the possession. Finally, only Puerto Rico and the U.S. Virgin Islands are within the scope of the FUTA obligations.[899] Wages paid to persons employed in Puerto Rico or the U.S. Virgin Islands are subject to FUTA on wages for each calendar year paid by a covered employer to each employee. Federal unemployment insurance payroll taxes are used to fund programs maintained by the local jurisdictions for the benefit of unemployed workers. Employers in such jurisdictions with programs approved by the Federal government may qualify for a credit of 5.4 percentage points against the 6.0 percent tax rate, making the minimum, net Federal unemployment tax rate 0.6 percent.[900]

Excise Taxes

U.S. excise taxes generally do not apply within the U.S. possessions. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles of manufacture brought into the United States from Puerto Rico and the Virgin Islands and withdrawn for consumption or sale.[901] These taxes are generally covered over to the respective treasuries. Articles imported from the United States into Puerto Rico, the Virgin Islands, Guam, and American Samoa are generally exempt from U.S. excise tax; however articles imported from the United States into Puerto Rico and the Virgin Islands are subject to a local excise tax equal to the tax imposed under the revenue laws of the United States.[902] Provisions related to the allowance of drawback[903] on excise tax on articles exported from the Unites States are extended

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[897] Internal Revenue Service, *Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands* (Publication 80 Circular SS), 2012.

[898] Under section 3401(a)(8), most wages paid to U.S. persons for services performed in one of the possessions are excluded if the payments are subject to withholding by the possession, or, in the case of Puerto Rico, the payee is a bona fide resident of the possession for the full year.

[899] Section 3306(j) provides that for purposes of the FUTA tax, the term State includes both Puerto Rico and the Virgin Islands.

[900] While the gross FUTA tax rate was 6.2 percent (until July 2011), the net rate was 0.8 percent. The credit is not available to employers who are delinquent in repaying a Federal loan.

[901] Sec. 7652.

[902] Sec. 7653.

[903] A drawback is a refund of certain duties, taxes and fees paid by the importer of record and granted to a drawback claimant upon the exportation, or destruction of eligible articles upon which the duties, taxes and fees have been paid. The purpose of drawback is to place U.S. exporters on equal footing with foreign competitors by refunding most of the duties, taxes and fees paid on imports used in domestic manufacturing intended for export.

to like articles when shipped from the United States to Puerto Rico, the Virgin Islands, Guam, or American Samoa.[904]

Tax Incentives

The Code contains other provisions that provide incentives for certain activities. Some of the provisions expand the incentives provided for State and local jurisdictions to the U.S. possessions while others are specifically targeted at certain activities within a specific U.S. possession. Examples of State and local incentives that apply to U.S. possessions include the exclusion of interest on State and local bonds,[905] the credit for research and experimentation,[906] and the low-income housing credit.[907] Other incentives are described in the discussion of the individual possessions below.

Tax Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income, such as dividends, interest, and royalties paid to residents of the other treaty country. Treaties also include provisions governing the creditability of taxes imposed by the treaty country in which income is earned in computing the amount of tax owed to the other country by its residents with respect to that income.

There are no bilateral tax treaties between any of the possessions and any foreign country. In addition, U.S. treaties typically do not include the possessions in the definition of United States for treaty purposes. However, for purposes of identifying the scope of exchange of information agreements, the possessions are included.[908] Treaties further provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries. To the extent that inconsistent positions are taken by the Internal Revenue Service and the taxing authority of one of the possessions, relief from double taxation may be available by negotiation between the two taxing agencies. Each of the U.S. possessions has an agreement (variously styled as coordination,

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[904] Sec. 7653(c).

[905] Sec. 103. Section 103(c)(2) defines State to include any possession of the United States.

[906] Sec. 41. The credit is generally not available to foreign research; however, section 41(d)(4)(F) defines foreign research to be research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

[907] Sec. 42. Section 42(h)(8)(B) defines State to include a possession of the United States.

[908] See, *e.g.*, *Agreement between the Government of the United State of America and the Government of the Republic of Panama for Tax Cooperation and the Exchange of Information Relating to Taxes Tax Information Agreement between United States and Panama*, entered into force April 18, 2011.

exchange of information, or implementation agreements) that permits entry into a memorandum of understanding to resolve such conflicts. The process for seeking such relief is similar to that available under competent authority procedures.[909]

[909] See section 1.02 of Rev. Proc. 2006-23, 2007-1 C.B. 900.

H. Present Law: Manufacturing

1. Brief overview of taxation of income derived from business activities

For Federal income tax purposes, businesses may be organized as various entities, including as a C corporation,[910] as a passthrough entity (*e.g.*, S corporation[911] or partnership), or as a sole proprietorship. A C corporation is taxed directly on its current income, but its shareholders are not, although they are taxed separately on distributions by the corporation. Conversely, Federal income tax does not normally apply at the entity level in the case of a passthrough entity. Rather, items of income, gain, or loss are taken into account for tax purposes by the partners or S corporation shareholders on their individual tax returns. Similarly, income from a sole proprietorship is included on the tax return of the individual owner. Below is an overview of the rules regarding the Federal income taxation of individuals and corporations.

Individual Income Tax

In general

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income.[912] Taxable income equals the taxpayer's total gross income less certain exclusions, exemptions, and deductions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may face additional liability if the alternative minimum tax applies. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

Adjusted gross income

Gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[913] trusts or estates.[914] Statutory exclusions from

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[910] A C corporation is so named because its Federal tax treatment is governed by subchapter C of the Code.

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

[912] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

[913] In general, partnerships and S corporations are treated as passthrough entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of such entities is passed through and taxed to the owners at the individual level.

[914] In general, estates and most trusts pay tax on income at the entity level, unless the income is distributed or required to be distributed under governing law or under the terms of the governing instrument. Such entities

gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include trade or business expenses, capital losses, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), certain moving expenses, certain education-related expenses, and alimony payments.

Taxable income

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2013, the amount deductible for each personal exemption is $3,900. This amount is indexed annually for inflation. However, the personal exemption phase-out ("PEP") reduces a taxpayer's personal exemption by two percent for each $2,500 by which the taxpayer's AGI exceeds a certain threshold. The thresholds for 2013 are $372,500 (single) and $422,500 (married filing jointly).

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2013, the amount of the standard deduction is $6,100 for single individuals and married individuals filing separate returns, $8,950 for heads of households, and $12,200 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[915] The amounts of the basic standard deduction and the additional standard deduction are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). However, the total amount of itemized deductions allowed is reduced for taxpayers with AGIs over a certain

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determine their tax liability using a special tax rate schedule and are subject to the alternative minimum tax. Certain trusts, however, do not pay Federal income tax at the trust level. For example, certain trusts that distribute all income currently to beneficiaries are treated as passthrough or conduit entities (similar to a partnership). Other trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

[915] For 2013, the additional amount is $1,200 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,500. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2013) of $2,400 or $3,000, as applicable.

threshold amount, which is indexed annually for inflation. For 2013, these income thresholds are $250,000 (single) and $300,000 (married filing jointly).

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax liability reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rates schedules apply. Lower rates apply for long-term capital gains; those rates apply for both the regular tax and the alternative minimum tax.

Regular tax liability

To determine regular tax liability, a 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. For 2013, the regular individual income tax rate schedules are as follows:

Table 19.–Federal Individual Income Tax Rates for 2013[916]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $87,850
Over $183,250 but not over $398,350	$44,306.25 plus 33% of the excess over $183,250
Over $398,350 but not over $400,000	$115,586.25 plus 35% of the excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000

[916] Rev. Proc. 2013-15, 2013-5 I.R.B. 44.

If taxable income is:	Then income tax equals:
Heads of Households	
Not over $12,750	10% of the taxable income
Over $12,750 but not over $48,600	$1,275 plus 15% of the excess over $12,750
Over $48,600 but not over $125,450	$6,652.50 plus 25% of the excess over $48,600
Over $125,450 but not over $203,150	$25,865 plus 28% of the excess over $125,450
Over $203,150 but not over $398,350	$47,621 plus 33% of the excess over $203,150
Over $398,350 but not over $425,000	$112,037 plus 35% of the excess over $398,350
Over $425,000	$121,364.50 plus 39.6% of the excess over $425,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,850	10% of the taxable income
Over $17,850 but not over $72,500	$1,785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50 plus 25% of the excess over $72,500
Over $146,400 but not over $223,050	$28,457.50 plus 28% of the excess over $146,400
Over $223,050 but not over $398,350	$49,919.50 plus 33% of the excess over $223,050
Over $398,350 but not over $450,000	$107,768.50 plus 35% of the excess over $398,350
Over $450,000	$125,846 plus 39.6% of the excess over $450,000
Married Individuals Filing Separate Returns	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $73,200	$4,991.25 plus 25% of the excess over $36,250
Over $73,200 but not over $111,525	$14,228.75 plus 28% of the excess over $73,200
Over $111,525 but not over $199,175	$24,959.75 plus 33% of the excess over $111,525
Over $199,175 but not over $225,000	$53,884.25 plus 35% of the excess over $199,175
Over $225,000	$62,923 plus 39.6% of the excess over $225,000

An individual's marginal tax rate may be reduced by the allowance of a deduction equal to a percentage of income from certain domestic manufacturing activities.[917]

[917] This deduction is described in more detail below.

Alternative minimum tax liability

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. 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 taxpayer's taxable income increased by the taxpayer's tax preferences 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.

For 2013 the exemption amounts are: (1) $80,800 in the case of married individuals filing a joint return and surviving spouses; (2) $51,900 in taxable years in the case of other unmarried individuals; (3) $40,400 in the case of married individuals filing separate returns; and (4) $23,100 in the case of an estate or trust.[918] The exemption amounts for 2013 are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $153,900 in the case of married individuals filing a joint return and surviving spouses, (2) $115,400 in the case of other unmarried individuals, and (3) $76,950 in the case of married individuals filing separate returns or an estate or a trust. These amounts are indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI.

Special capital gains and dividends rates

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

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[918] Rev. Proc. 2013-15, 2013-5 I.R.B. 44.

A separate rate structure applies to capital gains and dividends. The maximum statutory rate of tax on the adjusted net capital gain of an individual is 20 percent (exclusive of the additional 3.8-percent tax on net investment income). Under present law, any adjusted net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate; any adjusted net capital gain that otherwise would be taxed at a 25-, 28-, 33-, or 35-percent rate is taxed at a 15-percent rate; and any adjusted net capital gain that otherwise would be taxed at a 39.6 percent rate is taxed at a 20-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax ("AMT"). Dividends generally are taxed at the same rate as capital gains.

Tax on net investment income

A tax, known as the "unearned income Medicare contribution 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 or the excess of modified adjusted gross income over the threshold amount.[919] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

For purposes of the unearned income Medicare contribution tax, modified adjusted gross income is adjusted gross income increased by the amount of foreign earned income excluded from gross income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).[920]

Credits against tax

An individual may reduce his or her tax liability by any available tax credits. Tax credits are allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain education expenditures, certain dependent children and child care expenditures, and for certain elderly or disabled individuals. In addition, a refundable earned income tax credit ("EITC") is available to low-income workers who satisfy certain requirements. The amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has one, two, more than two, or no qualifying children. In 2013, the maximum EITC is $6,044 for taxpayers with more than two qualifying children, $5,372 for taxpayers with two qualifying children, $3,250 for taxpayers with one qualifying child, and $487 for taxpayers with no qualifying children. Credits allowed against the regular tax are not uniformly allowed against the alternative minimum tax.

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[919] The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

[920] In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. The tax does not apply to a nonresident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

Corporate Income Tax

Taxable income

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.[921] However, a qualified small business corporation may elect, under subchapter S of the Code, not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation flows through to the shareholders and is taxable directly to the shareholders.

The taxable income of a corporation generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization, or depletion allowances. A net operating loss incurred in one taxable year may be carried back two years or carried forward 20 years and allowed as a deduction in another taxable year. Deductions also are allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

The Code also specifies certain expenditures that may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[922] certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, penalties, bribes, kickbacks and illegal payments.

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[921] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

[922] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

Tax liability

A corporation's regular income tax liability generally is determined by applying the following tax rate schedule to its taxable income.

Table 20.–Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0-$50,000	15 percent of taxable income
$50,001-$75,000	25 percent of taxable income
$75,001-$10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

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

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the Code.[923]

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include credits for producing fuels from nonconventional sources, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the alcohol fuels credit (applicable to production of certain alcohol fuels), the research credit, the low-income housing credit (applicable to investment in certain low-income housing projects), the empowerment zone employment credit

[923] The domestic production deduction is discussed in more detail below.

(applicable to wages paid to certain residents of or employees in empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals). The credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses (and credits) of one corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Minimum tax

A corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[924] Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences 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. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's adjusted current earnings exceed its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings

[924] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

and profits.[925] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[926] Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at a rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder level tax in addition to the corporate level tax on accumulated earnings or undistributed personal holding company income.

2. Capital expenditures

Current expenditures versus capital expenditures

Section 162 generally allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. A capital expenditure, however, generally is not currently deductible. Instead, capital expenditures generally are recovered over an appropriate period as discussed below. Section 263 defines a capital expenditure as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. A capital expenditure also includes any amount expended for restoring property or in making good the exhaustion thereof for which an allowance (for depreciation, amortization or depletion) is or has been made. Treasury regulations state that capital expenditures generally include amounts paid or incurred "to add to the value, or substantially

[925] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

[926] This double taxation is mitigated by a reduced maximum tax rate of 20 percent generally applicable to dividend income of individuals.

prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or to adapt property to a new or different use."[927] Treasury regulations also state that capital expenditures generally include "the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."[928]

In 1974, the Supreme Court stated that the "purpose of section 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."[929] The courts also have recognized that, although an expenditure may provide some future benefit, the amount of the expenditure may be so small as not to warrant capitalization. For example, a taxpayer was permitted a current deduction for capital costs of less than $500 per item because requiring capitalization would be a significant burden on the taxpayer.[930] Moreover, the court held, any distortion of income would be minimal and "no provision in the Code is so inflexible as to call for that intractable a result."[931]

In 1992, the Supreme Court again addressed the issue of capitalization. In *INDOPCO v. Commissioner*,[932] the taxpayer, a corporation, incurred legal and professional fees as the result of being the target of a friendly acquisition. The Court required the taxpayer to capitalize these fees, because it concluded that the costs created significant long-term benefits. The Court specifically rejected the taxpayer's position that only expenditures that create or enhance a separate and distinct asset are capital expenditures.[933] In addition, the Court stated, "[a]lthough the mere presence of an incidental future benefit − 'some future aspect' − may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is

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[927] Treas. Reg. sec. 1.263(a)-1(b). In an attempt provide additional guidance with respect to these factually intensive rules, the government is looking to issue revised regulations addressing the treatment of payments to acquire, produce, or improve tangible property. As part of this effort, the government withdrew regulations proposed in 2006 and 2008 and replaced them with temporary and proposed regulations in 2011, generally effective for taxable years beginning on or after January 1, 2014. Treas. Reg. sec. 1.263(a)-1T, -2T, -3T, and -6T, T.D. 9564 and Reg. 168745-03 (December 27, 2011).

[928] Treas. Reg. sec. 1.263(a)-2(a).

[929] *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

[930] *Cincinnati, New Orleans & Texas Pacific Railway. Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970).

[931] *Ibid.*, p. 572.

[932] 503 U.S. 79 (1992).

[933] The taxpayer's argument was in part based upon its interpretation of the Supreme Court's decision in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), which held that only expenditures that create or enhance a separate and distinct asset are to be capitalized.

incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[934]

In 2004, Treasury promulgated final regulations that addressed the treatment of intangibles as well as amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. The intangible property regulations provide that capitalization generally is required for an amount paid to acquire or create an intangible, create or enhance a separate and distinct intangible asset, create or enhance a future benefit identified in published guidance as an intangible for which capitalization is required, and to facilitate an acquisition or creation of an intangible asset.[935] The amount required to be capitalized generally is added to the basis of the intangible acquired or created.[936] These regulations, however, do not impact the present law treatment of any amount specifically addressed under any other section of the Code with the exception of sections 162 and 212 as well as the Treasury regulations thereunder. For example, amounts deductible under section 174 as research and experimentation expenditures are not required to be capitalized under the intangible property regulations.

The regulations also address amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions that require the capitalization of amounts paid to facilitate those transactions. Under these rules, capitalization may be required where the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized on the transaction.[937] In general, an amount is treated as paid to facilitate a

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[934] *INDOPCO,* 503 U.S. at 87.

[935] Treas. Reg. sec. 1.263(a)-4. However, under "the 12-month rule," a taxpayer is not required to capitalize amounts paid to create (or facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of: (1) 12 months after the first date on which the taxpayer realizes the right or benefit or (2) the end of the tax year following the tax year in which the payment is made. Treas. Reg. sec. 1.263(a)-4(f).

[936] Sec. 1012.

[937] Treas. Reg. sec. 1.263(a)-5. Transactions to which the regulations apply include: (1) an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer or target of the acquisition; (2) an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b); (3) an acquisition of an ownership interest in the taxpayer (other than such an acquisition by the taxpayer); (4) a restructuring, recapitalization, or reorganization of the capital (including transactions described in sections 368 and 355); (5) a transfer described in section 351 or section 721 whether the taxpayer is the transferor or transferee); (6) a formation or organization of a disregarded entity; (7) an acquisition of capital; (8) a stock issuance; (9) a borrowing; and (10) writing an option. Treas. Reg. sec. 1.263(a)-5(a).

Section 1.263(a)-5(f) provides that an amount that is contingent on the successful closing of a transaction described in § 1.263(a)-5(a) ("success-based fee") is presumed to facilitate the transaction. A taxpayer may rebut the presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. As the treatment of success-based fees has been the subject of controversy, the Service recently issued guidance providing a safe harbor for the treatment of success-based fees. Under the safe harbor, the Service will not challenge a taxpayer's allocation of a success-based fee between activities that facilitate a transaction described in § 1.263(a)-5(e)(3) and activities that do not facilitate the transaction if the taxpayer treats

transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Subject to a special rule that requires capitalization of amounts that are treated as inherently facilitative,[938] an amount paid by a taxpayer in the process of investigating or otherwise pursing a covered transaction is treated as facilitating the transaction only if the amount relates to activities performed on or after the earlier of the following dates: (1) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (2) the date on which the material terms of the transaction as tentatively agreed to by representatives of the acquirer and the target are authorized or approved by the taxpayer's board of directors (or its committee) or other representatives as authorized or approved by governing officials of the taxpayer (in circumstances where the taxpayer is not a corporation).[939]

For this purpose, a "covered transaction" includes: (1) a taxable acquisition by the taxpayer of assets that constitute a trade or business; (2) a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b); and (3) certain reorganization transactions under section 368 (whether the taxpayer is the acquirer or the target in the reorganization).[940]

3. Cost recovery for capital expenditures

Background

Economic depreciation

Cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property. The Federal income tax law permits this recoupment through the allowance of deductions for depreciation or amortization, or expensing (current year deduction of the cost of property). In lieu of (or in addition to) cost recovery, tax credits may be given to incentivize investment in capital assets.

Conceptually, depreciation could be viewed as reflecting the decline in value over time of business or income-producing property, as the ageing of the property causes it to lose value. In

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70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction and capitalizes the remaining 30 percent as an amount that does facilitate the transaction. Rev. Proc. 2011-29; 2011-18 IRB 746.

[938] An amount is generally treated as inherently facilitative if it is paid for: (1) securing an appraisal, formal written evaluation, or fairness opinion related to the transaction; (2) structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction; (3) preparing and reviewing the documents that effectuate the transaction; (4) obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings; (5) obtaining shareholder approval of the transaction; or (6) conveying property between the parties to the transaction. Treas. Reg. sec. 1.263(a)-5(3)(2).

[939] Treas. Reg. sec. 1.263(a)-5(e)(1).

[940] Treas. Reg. sec. 1.263(a)-5(e)(3).

other words, depreciation could be viewed as representing the decline over time in the present value of income produced by the property, as its income-producing utility diminishes. Tax and economic depreciation can diverge.

Quantifying economic depreciation is not straightforward. Does a decline to zero, in equal annual increments, of the cost of property over the life of the property reflect economic depreciation? This generally is the method for calculating straight-line depreciation under the tax law. Since the 1970s, economic literature has suggested that economic depreciation diverges from straight-line depreciation over the life of an asset. Specifically, economic analysis suggests that economic depreciation may be better reflected by a constant rate of decline rather than a constant amount.[941]

Cost recovery under the income tax

Historically, depreciation deductions have been allowed under the Federal income tax system as a reasonable allowance for the exhaustion, or wear and tear (including obsolescence), of business property or of property held for the production of income.[942] Since 1981,[943] however, depreciation has been calculated under the Federal income tax system generally by applying a depreciation method to a recovery period for the category of property being depreciated.[944] Similarly, amortization of many intangible assets has, since 1993, been determined on the straight-line method over a 15-year period.[945] Some expensing is permitted for business property subject to annual dollar limitations under present law.[946] Tax credits are provided with respect to capital investment in certain types of property, including some types of energy-related property.[947]

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[941] Economists have assessed divergences between tax and economic depreciation. See Joint Committee on Taxation, *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012, section III for a detailed discussion.

[942] Sec. 167.

[943] Secs. 201-211 of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34. In 1981, the new depreciation system was explained in this manner: "The Act replaces the prior law depreciation system with the Accelerated Cost Recovery System (ACRS). ACRS is a system for recovering capital costs using accelerated methods over predetermined recovery periods that are generally unrelated to, but shorter than, prior law useful lives." Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, pp. 75-76. The provisions have been modified legislatively several times since 1981.

[944] Sec. 168.

[945] Sec. 197.

[946] Sec. 179.

[947] For a summary and analysis of present-law energy-related investment credits, see Joint Committee on Taxation, *Present Law and Analysis of Energy-Related Tax Expenditures and Description of the Revenue Provisions Contained in H.R. 1380, the New Alternative Transportation to Give Americans Solutions Act of 2011* (JCX-47-11), September 20, 2011.

In the absence of depreciation deductions, the decline in value of income-producing property would not be recognized as a deduction or loss in an income tax system that generally requires a recognition event − such as a sale or exchange of the property − in order for gain or loss to be taken into account for tax purposes.

Ascertaining the specific decline in value of each piece of business property for each year that the property is used in the business presents measurement difficulties. Even if the cost of the property is spread formulaically over the property's useful life in the business, administrative difficulties arise in predicting, estimating, or otherwise ascertaining the useful life of the property. These and related difficulties have made the use of a less fact-dependent depreciation system attractive to taxpayers and to the government from a tax administration standpoint. [948]

Depreciation methods can be adjusted to provide a greater or lesser degree of acceleration of cost recovery for the taxpayer with respect to the depreciable property. For example, for a given cost recovery period, a declining-balance method, in which the taxpayer's depreciation deduction is greatest in the early years of the cost recovery period and smaller in the later years, is more accelerated than the straight-line method, in which the taxpayer's depreciation deduction for the property is the same for each year in the cost recovery period. Although the same cost for the property is recovered over the same recovery period under both depreciation methods, the more accelerated method provides a larger overall cost recovery for the taxpayer. The acceleration of a greater amount of the deduction into the earlier years of the recovery period means that the present value of the tax benefit to the taxpayer is greater under the accelerated method than under the straight-line method.

A formulaic system of depreciation can serve to provide a tax incentive for capital investment to the extent the depreciation deductions are faster than the economic or financial statement depreciation of the property. For example, temporary rules providing for additional first-year depreciation (also known as bonus depreciation) were enacted several times in recent legislation with the purpose of providing economic stimulus during times of economic downturn.[949]

Expensing, or allowing a deduction for the cost of business property in the year it is placed in service, provides a tax benefit of a greater present value than depreciation, including accelerated depreciation, because the full cost of the property is recovered in the first year rather than in subsequent years. Expensing the full cost of the property is economically equivalent to exempting from tax the so-called "normal" return on investment, assuming tax rates remain the same.[950]

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[948] For a more detailed overview of the evolution of the tax depreciation rules, see*, inter alia*, Boris I. Bittker and Lawrence Lokken, "Depreciation and Amortization - Introductory," *Federal Taxation of Income, Estates and Gifts* (3d. ed. 1999) par. 23.1.

[949] Sec. 168(k).

[950] For comparative depreciation examples, see Joint Committee on Taxation, *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012.

A tax credit also can serve as a form of cost recovery or may permit recovery of an amount different from the cost of the property. Prior to 1986, an investment tax credit was allowed for up to 10 percent of a taxpayer's investment in certain tangible depreciable property (generally not including buildings or their structural components). The taxpayer could not reduce its tax liability by more than the sum of a specified dollar amount plus a percentage of the tax liability in excess of that amount, though a carryover was provided for unused credits. The investment tax credit was repealed as part of the Tax Reform Act of 1986.[951] However, the Code currently provides tax credits for investments in specified types of property, including the rehabilitation credit, the low-income housing credit, and credits for energy-related property.[952]

4. Cost recovery for tangible assets

Depreciation

Legislative background

In general

To account for the wear and tear, deterioration, or obsolescence of its property, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. As described in 1985, the depreciation system in place prior to 1981 provided that…

1. "[c]lass lives are generally based on guideline lives established for the Asset Depreciation Range ("ADR") system of depreciation that was adopted in 1971. Under the ADR system, a present class life was provided for all assets used in the same activities, other than certain assets with common characteristics (*e.g.*, automobiles). Assets were grouped into more than 100 classes and a guideline life was determined by the former Office of Industrial Economics in the Treasury Department. The guideline lives established under the ADR system were about 30 to 40-percent shorter than the service lives found in Bulletin F, a publication concerning useful lives issued in 1942 by the Internal Revenue Service."[953]

In 1981, the prior-law ADR and useful life systems were replaced by a new system, the accelerated cost recovery system ("ACRS"),[954] which permitted "recovery of capital costs for most tangible depreciable property using accelerated methods of cost recovery over predetermined recovery periods generally unrelated to, but shorter than, [prior] law useful

[951] Pub. L. No. 99-514, sec. 211.

[952] Secs. 47 (rehabilitation credit), 42 (low-income housing credit) and, *e.g.*, 45 (credit for electricity produced from renewable sources) and 48C (advanced energy project credit).

[953] Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985, p. 48.

[954] The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, sec. 202 (1981).

lives."[955] The Senate Finance Committee Report with respect to the provision explained the rationale for the change: "[t]he committee believes that the present rules for determining depreciation allowances . . . need to be replaced because they do not provide the investment stimulus that is essential for economic expansion. The real value of depreciation deductions allowed under present rules has declined for several years due to successively higher rates of inflation. . . . The committee therefore believes that a new capital cost recovery system is required which provides for the more rapid acceleration of cost recovery deductions . . . ."[956]

These rules were tightened somewhat in 1982,[957] and modified more substantially in 1986,[958] when the modified accelerated cost recovery system ("MACRS") was adopted. The 1986 legislation enacting MACRS further accelerated the rate of recovery of depreciation deductions from the 150-percent declining balance method to the 200-percent declining balance method for those tangible assets with the shortest class lives.[959] In addition, under the 1986 legislation, certain assets were reclassified and the number of asset classes was increased. The 1986 legislation also extended the recovery period for residential rental property to from 19 to 27.5 years and from 19 to 31.5 years for nonresidential real property, and provided that their cost would be recovered using the straight-line method. The recovery period for nonresidential real property was extended to 39 years in 1993.[960]

Recovery periods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. 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.

When the MACRS system was enacted in 1986, Congress explicitly categorized certain assets by type of property.[961] Further, Congress directed the Secretary of the Treasury to establish an office to monitor and analyze actual experience with respect to depreciable assets and authorized the Secretary to prescribe or modify class lives for depreciable assets, provided that the new class life reasonably reflected the anticipated useful life and the anticipated decline in value over time of the property to the industry or other group.

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[955] S. Rep. No. 97-144, p. 48 (1981).

[956] *Ibid*. p. 47.

[957] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, sec. 206 (1982).

[958] The Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 201 (1986).

[959] 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.

[960] The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13151(a) (1993).

[961] See Table 21 which summarizes the various types of property and applicable recovery periods under MACRS.

Exercising the authority granted by Congress, the Secretary issued Revenue Procedure 87-56,[962] laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22.[963]

In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property as part of the Technical and Miscellaneous Revenue Act of 1988.[964] Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets,[965] effectively superseding any administrative guidance with regard to such property.

Prior and present law

In general

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under MACRS whereby different types of property generally are assigned applicable recovery periods and depreciation methods.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years.[966] The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[967] switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year will yield a larger depreciation allowance. The recovery periods for most real property are 39 years (for nonresidential real property) and 27.5 years (for residential rental property). Table 21 provides general rules for class lives and recovery periods as provided in section 168(e).

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[962] 1987-2 C.B. 674.

[963] 1988-1 C.B. 785.

[964] Pub. L. No. 100-647, sec. 6253 (1988).

[965] See below for a list of statutory recovery periods.

[966] For certain tangible assets, the recovery period is controlled by statute (see, *e.g.*, below, which includes a table of statutorily defined recovery periods for specific types of property). For all other tangible assets, the recovery period is generally determined by administrative guidance (see, *e.g.*, Rev. Proc. 87-56, 1987-2 CB 674, and Appendix B of IRS Publication 946).

[967] Declining balance methods accelerate a portion of the total allowable deductions into the earlier years of the recovery period. For example, under the 200-percent declining balance method, the deduction in the first year is twice what it would be under the straight-line method, but the annual allowance amount declines over the recovery period. The allowable amount is thus smaller in the later years than the allowable amounts for those years would have been under the straight-line method.

Table 21.−General Rules for Class Lives and Recovery Periods

Type of Property	General Rule-Class Life	Applicable Recovery Period
3-year property	4 years or less	3 years
5-year property	More than 4 but less than 10 years	5 years
7-year property	10 or more but less than 16 years; also, property (other than real property) without a class life	7 years
10-year property	16 or more but less than 20 years	10 years
15-year property	20 or more but less than 25 years	15 years
20-year property	25 or more years	20 years
Water utility property	50 years	25 years
Residential rental property	40 years	27.5 years
Nonresidential real property	40 years	39 years
Any railroad grading or tunnel bore	50 years	50 years

Placed-in-service conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention. 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. 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. However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter convention,[968] designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

Depreciation under the alternative minimum tax regime

In determining the amount of alternative minimum taxable income for any taxable year, taxpayers generally are required to calculate depreciation for certain assets under modified rules. Specifically, assets to which the 200-percent declining balance method is applicable under

[968] 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.

MACRS are depreciated using the 150-percent declining balance method for purposes of computing alternative minimum taxable income.[969]

In addition, for property placed in service after December 31, 1986, and on or before December 31, 1998, depreciation for alternative minimum tax purposes is calculated using the longer recovery periods of the alternative depreciation system described below.[970]

Alternative depreciation system

The alternative depreciation system ("ADS") is required to be used for property used predominantly outside the United States, tax-exempt bond financed property, and certain tax-exempt use property.[971] An election to use ADS is available to taxpayers for any class of property for any taxable year.[972] Under ADS, all property is depreciated using the straight-line method, over recovery periods which generally are longer than those used under MACRS. Bonus depreciation, discussed below, is not available for property required to be depreciated using ADS.[973]

Additional First-Year Depreciation Deduction ("Bonus Depreciation")

Legislative background

For the past decade, Congress has provided additional first-year depreciation deductions for assets placed in service in certain years. The first instance of bonus depreciation came in the Job Creation and Worker Assistance Act of 2002,[974] which provided an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[975] Subsequent legislation[976] has provided additional first-year depreciation equal to 50 percent and

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[969] Sec. 56(a)(1)(A)(ii).

[970] Sec. 56(a)(1)(A)(i).

[971] Sec. 168(g).

[972] Sec. 168(g)(7).

[973] Sec. 168(k)(2)(D)(i).

[974] Pub. L. No. 107-147, sec. 101 (2002).

[975] A taxpayer is permitted to elect out of the additional first-year depreciation deduction for any class of property for any taxable year.

[976] The Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub. L. No. 108-27, sec. 201) provided an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property was generally defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction, subject to the applicable time period set forth in the provision. The provision also extended the 50-percent additional first-year depreciation deduction to certain property with a recovery period of 10 years or longer and certain transportation property. The American Jobs Creation Act of 2004 (Pub. L. No. 108-357, sec. 211) 2004 expanded the definition of eligible property to include certain leasehold improvements and qualified restaurant

100 percent for qualifying property. The basis of the property and the depreciation allowances in the placed-in-service year and later years were appropriately adjusted to reflect the additional first-year depreciation deduction.

To qualify for the additional first-year depreciation deduction, the property must have been: (1) property to which the general rules of MACRS applied with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197,[977] or (4) qualified leasehold improvement property (as defined in section 168(k)(3)). In addition, the taxpayer must have acquired the property for its original use and placed the property in service within the applicable time period. An extension of the placed-in-service date of one year was provided for certain property with a recovery period of 10 years or longer and certain transportation property.[978]

Example.−A taxpayer places in service machinery that is categorized as a seven-year asset.[979] By electing 50-percent bonus depreciation for this asset class, the taxpayer is eligible to deduct 57 percent (50 percent + (remaining 50 percent x 14.29 percent)) of the asset's basis during the first year. Without bonus depreciation, the same taxpayer deducts only 14.29 percent of the asset's basis during the first year.

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property. Section 336 of this Act also made the long production period extended placed-in-service dates available for certain noncommercial aircraft.

The Economic Stimulus Act of 2008 (Pub. L. No. 110-185, sec. 103) reinstated 50-percent bonus depreciation for property acquired in 2008. The American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5, sec. 1201) extended the additional first-year depreciation deduction for one year, generally through 2009. The Small Business Jobs Act of 2010 (Pub. L. No. 111-240, sec. 2022) extended the additional first-year depreciation deduction for another year, generally for assets placed in service through 2010; further, for qualifying property (property otherwise eligible for bonus depreciation that had a MACRS recovery period of 7 years or less) placed in service in 2010, the taxpayer was not required to allocate the additional first-year depreciation deduction to related section 460 contracts. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312, sec. 401) extended 50-percent bonus depreciation through 2012, provided 100-percent bonus in lieu of 50-percent bonus for qualified property placed in service after September 8, 2010, and before January 1, 2012. The American Taxpayer Relief Act of 2012 (Pub. L. No. 112-240, sec. 331) extended 50-percent bonus depreciation for qualified property placed in service before January 1, 2014. A one-year extension of the placed-in-service date was provided for certain longer-lived and transportation property in each of these provisions.

[977] See below for a discussion of section 197.

[978] In order for the property to qualify for the extended placed in service date, the property was required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding $1 million.

[979] This example assumes the first-year depreciation is calculated using the half-year convention.

Present law

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service between December 31, 2007 and January 1, 2014 (January 1, 2015 for certain longer-lived and transportation property).[980]

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[981] Second, the original use[982] of the property must commence with the taxpayer after December 31, 2007.[983] Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2014. An extension of the placed-in-service date of one year (*i.e.*, January 1, 2015) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.[984] Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property.[985]

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[980] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

[981] 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. The additional first-year depreciation deduction also is not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

[982] 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).

[983] 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.

[984] Property qualifying for the extended placed-in-service date must have an estimated production period exceeding one year and a cost exceeding $1 million.

[985] Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed in service date, if at the time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or $100,000, and which has an estimated production period exceeding four months and a cost exceeding $200,000.

To qualify for the additional first-year depreciation deduction, property generally must be acquired (1) after December 31, 2007, and before January 1, 2014 (before January 1, 2015 in the case of certain longer-lived and transportation property), but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2014.[986] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2014. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2014 is eligible for the additional first-year depreciation deduction.[987]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

In the case of the additional first-year depreciation deduction, the basis of the property is appropriately adjusted to reflect the additional first-year depreciation deduction. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits.[988] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

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[986] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

[987] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

[988] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

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). The $8,000 increase is not indexed for inflation.

Election to accelerate alternative minimum tax and research credits in lieu of bonus depreciation

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional minimum tax credits in lieu of claiming additional first-year depreciation under section 168(k) for "eligible qualified property" placed in service after December 31, 2010 and before January 1, 2014 (January 1, 2015 in the case of certain longer-lived and transportation property).[989] A corporation making the election increases the limitation under section 53(c) on the use of minimum tax credits in lieu of taking bonus depreciation deductions. The increases in the allowable credits under this provision are treated as refundable. The depreciation for eligible qualified property is calculated for both regular tax and alternative minimum tax purposes using the straight-line method in place of the method that would otherwise be used absent an election under this provision.

The minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation[990] for certain eligible qualified property that could be claimed as a deduction absent an election under this provision.

The bonus depreciation amount is limited to the lesser of (1) $30 million or (2) six-percent of the minimum tax credits allocable to the adjusted minimum tax imposed for, taxable years beginning before January 1, 2006. 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.

A separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to property that is eligible solely by reason of the extension of bonus depreciation in the 2010 Tax Relief Act ("round 2 extension property") and property that is eligible solely by reason of the extension of bonus depreciation in American Taxpayer Relief Act of 2012 ("round 3 extension property").[991] A corporation that has previously made an

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[989] Sec. 168(k)(4). Eligible qualified property means qualified property eligible for bonus depreciation with minor effective date differences.

[990] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and the shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

[991] Pub. L. No. 112-240, sec. 331 (2013). An election under new section 168(k)(4)(J) with respect to round 3 extension property is binding for any property that is eligible qualified property solely by reason of the amendments made by section 331(a) of the Act (and the application of such extension to this paragraph pursuant to the amendment made by section 331(c)(1) of the Act), even if such property is placed in service in 2014. In

election to claim credits in lieu of bonus depreciation may choose not to make this previous election apply for round 3 extension property. Similarly, the provision allows a corporation that has not made a previous election to claim credits in lieu of bonus deprecation to make the election for round 3 extension property for its first taxable year ending after December 31, 2012, and for each subsequent year.[992]

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, section 168(k)(1) does not apply to any eligible qualified property and the straight-line method is used with respect to such property.

Expensing Provisions

Present law

A taxpayer may elect under section 179 to deduct (or expense) the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation.[993] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2014 also is treated as qualifying property. Further, for taxable years beginning before 2014, qualifying property also includes certain real property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[994]

For taxable years beginning in between 2010 and 2013, the maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year.[995] 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.[996] The $500,000 and $2,000,000 amounts are not indexed for inflation. Of the $500,000 expense

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computing the maximum amount, the maximum increase amount for round 3 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to round 3 extension property.

[992] Special election rules apply as the result of prior extensions of this provision.

[993] Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

[994] Sec. 179(f).

[995] For the 2008 and 2009 years, the relevant dollar amounts were $250,000 and $800,000 (enacted as part of The Economic Stimulus Act of 2008, Pub. L. No. 110-185, sec. 102(a) (2008)).

[996] Sec. 179(b)(2).

amount available under section 179 for these years, the maximum amount available with respect to qualified real property is $250,000 for each taxable year.[997]

For taxable years beginning after 2013, a taxpayer may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Qualifying property does not include off-the-shelf computer software or qualified real property.

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). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However, amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property.[998] Thus, if a taxpayer's section 179 deduction for 2012 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2013. Any such carryover amounts that are not used in 2013 (due to taxable income limitations) are treated as property placed in service in 2013 for purposes of computing depreciation. That is, the unused carryover amount from 2012 is considered placed in service on the first day of the 2013 taxable year.[999]

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[1000] In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under section 179 may be revoked by the taxpayer without consent of

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[997] Sec. 179(f)(3).

[998] Section 179(f)(4) details the special rules that apply to disallowed amounts.

[999] For example, assume that during 2012, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2012, and has a taxable income limitation of $150,000. The maximum section 179 deduction the company can claim for 2012 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2013 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.

Assume further that in 2013, the company had no asset purchases and had taxable income of $-0-. The $100,000 carryover from 2012 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2013 taxable year. The $50,000 carryover allocated to equipment is carried over to 2014 under section 179(b)(3)(B).

[1000] Sec. 179(c)(1).

the Commissioner for taxable years beginning before 2014 (once made, such revocation is irrevocable).[1001]

Tax Credits for Capital Investment

Energy-related credits

Since the repeal of the prior-law investment tax credit in 1986,[1002] a number of tax credits for investment in energy-related property have been modified, expanded, or newly enacted.[1003]

General business credits that may impact capital investment

In addition, businesses are allowed a variety of other tax credits as part of the general business credit. While these include several employment-related credits for employers, others relate to specific types of investment in real estate, such as the low-income housing credit and the rehabilitation credit.

Low-income housing credit

The low-income housing credit[1004] may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments of the credit have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

[1001] Sec. 179(c)(2).

[1002] Sec. 211 of Pub. L. No. 99-514, the Tax Reform Act of 1986.

[1003] For a summary and analysis of present-law energy-related investment credits, see Joint Committee on Taxation, *Present Law and Analysis of Energy-Related Tax Expenditures and Description of the Revenue Provisions Contained in H.R. 1380, the New Alternative Transportation to Give Americans Solutions Act of 2011* (JCX-47-11), September 20, 2011.

[1004] Sec. 42.

Rehabilitation credit

Present law provides a two-tier tax credit for rehabilitation expenditures.[1005]

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. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

5. Cost recovery for intangible assets

In General

Section 167, in general, allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. While section 168[1006] provides the specific cost recovery (*i.e.*, depreciation) rules for most tangible assets, section 197 governs the cost recovery (*i.e.*, amortization) of many intangible assets. Cost recovery for tangible assets not covered by section 168 and intangible assets other than section 197 intangibles is provided by other sections of the Code.[1007]

15-year Amortization of Certain Acquired Intangibles

Legislative background

Similar to the codification of recovery periods for certain tangible assets and in order to minimize controversy and simplify the Code, in 1993, the Congress changed the rules regarding

[1005] Sec. 47.

[1006] See section above for a detailed discussion of section 168.

[1007] See, *e.g.*, sections 167, 195, 248, and 709.

amortization of goodwill and certain other acquired intangibles to require 15 year straight-line amortization for all such intangibles.[1008] Treasury regulations under prior law had permitted depreciation or amortization for the cost or other basis of acquired intangibles only if the property had "a limited useful life that may be determined with reasonable accuracy."[1009] The Treasury regulations also stated that no depreciation was allowed with respect to goodwill.[1010] However, taxpayers litigated whether intangibles such as a "customer base" could be amortized if shown to have a determinable value and useful life. The U.S. Supreme Court held that a taxpayer able to prove that a particular asset could be valued, and that the asset had a limited useful life that could be estimated with reasonable accuracy, was able to depreciate the asset over the useful life regardless of how much the asset appeared to reflect the expectancy of continued patronage. However, the Supreme Court also characterized the taxpayer's burden as "substantial" and stated that it "often will prove too great to bear."[1011] The enactment of section 197 mitigated much controversy that surrounded valuing and determining the useful life of certain intangible assets, such as goodwill.

Present law

Under section 197 of the Code, 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.[1012] 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. They also include any license, permit, or other rights granted by governmental units [1013] (even if the right is granted for an indefinite period or is reasonably expected to be

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[1008] Pub.L. No.103-66, Omnibus Budget Reconciliation Act of 1993, sec. 13261 (Aug. 10, 1993), adding section 197 to the Code. For a description of the reasons for change, see H.R. Rep. 103-111, Report of the Committee on the Budget, House of Representatives, to accompany H.R. 2264 (May 25, 1993) p. 760 and H.R. Rep. 103-213, Conference Report of the Committee on the Budget, House of Representatives, to accompany H.R. 2264, p. 672-696.

[1009] Treas. Reg. sec. 1.167(a)-(3).

[1010] *Ibid.*

[1011] *Newark Morning Ledger Co v. United States,* 507 U.S. 541 (April 20, 1993).

[1012] Secs. 197(d)(1)(F) and 197(f)(4). A franchise is included in the definition of a section 197 intangible. A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

[1013] 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).

renewed indefinitely); any covenant not to compete; and any franchise, trademark or trade name. In 2004, sports franchises were added to the assets subject to the 15-year amortization period.[1014]

However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not be amortized over the 15-year period provided in section 197, but instead must be amortized over the period of the grant of the right.[1015] Also, certain financial interests, certain computer software readily available for purchase by the general public, and certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof) are not subject to the 15-year amortization. Also, self-created assets, such as goodwill created through advertising and other expenses, are not subject to the provision.[1016]

If there is a disposition of one or more section 197 intangible assets acquired in a transaction or series of related transactions (or any such intangible becomes worthless), and one or more other section 197 intangibles acquired in such transaction or series of related transactions are retained, no loss is allowable until all such section 197 assets are disposed of, and the basis of those assets are adjusted for any loss not recognized.[1017]

Section 197 contains anti-churning rules that apply to prevent pre-section 197 goodwill, going concern value, or intangibles that would not have been amortizable but for section 197 from being transferred among related parties and becoming eligible for the 15-year amortization.[1018]

6. Start-up expenditures[1019]

A taxpayer may elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[1020] A corporation or a partnership may elect to deduct up $5,000 of organizational expenditures in the taxable year in which the active trade or

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[1014] Sec. 886 of Pub. L. No. 108-357 (October 22, 2004), the American Jobs Creation Act of 2004.

[1015] Sec. 197(e)(2). Treas. Reg. sec. 1.197-2(c)(3). An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. Treas. Reg. Sec. 1.197-2(c)(3).

[1016] Thus, section 197 does not require costs attributable to such assets to be capitalized under section 197 and amortized over 15 years.

[1017] Sec. 197(f)(1).

[1018] Sec. 197(f)(9).

[1019] Similar rules apply to organizational expenditures under section 248. Organizational expenditures are defined as any expenditure which (1) is incident to the creation of the corporation, (2) is chargeable to capital account, and (3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. Sec. 248(b).

[1020] Sec. 195(b)(1)(A).

business begins.[1021] However, in each case, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000.[1022] Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins. Absent an election to deduct and amortize start-up or organizational expenditures, such amounts are properly chargeable to capital and recovered when the business is sold, exchanged, or otherwise disposed.

Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation or the organization of a partnership, are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

7. Other cost recovery provisions

In general

Section 167 provides special rules for some tangible and intangible assets. Specifically, section 167 provides rules with respect to computer software,[1023] certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof) that are not governed under section 197, mortgage servicing rights,[1024] and geological and geophysical expenditures.[1025] The cost of motion picture films, sound recordings, copyrights, books, and patents also are depreciated under section 167.

Certain interests or rights acquired separately

The recovery period for certain interests or rights (*e.g.*, patent or copyright), not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof,[1026] is determined by the usefulness of the asset to

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[1021] Secs. 248(a)(1)(B), and 709(b)(1)(A)(ii).

[1022] *Ibid*. However, for taxable years beginning in 2010, the Small Business Jobs Act of 2010, Pub. L. No. 111-240, increased the amount of start-up expenditures a taxpayer could elect to deduct to $10,000, with a phase-out threshold of $60,000.

[1023] Section 167(f)(1) provides that costs of computer software shall be recovered ratably over 36 months.

[1024] Section 167(f)(3) provides that costs incurred to obtain mortgage servicing rights shall be recovered ratably over 108 months.

[1025] Section 167(h) provides that geological and geophysical ("G&G") expenditures shall be recovered ratably over 24 months. However, major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007.

[1026] Secs. 167(f)(2) and 197(e)(4)(B), (C), and (D).

the taxpayer. To the extent a certain interest or right is known to be of use for only a limited period of time, the length of which can be estimated with reasonable accuracy, such an intangible asset may be recovered over the useful life of the asset.[1027] For certain interests or rights with an undeterminable useful life, a 15-year safe harbor amortization period may be available.[1028]

Income forecast method

The cost of motion picture films or video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.[1029] 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 was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in that year.

In general, the adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). An exception to this rule applies to participations and residuals.[1030] Solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service (even if economic performance has not yet occurred) if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service. For this purpose, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property.

The inclusion of participations and residuals in adjusted basis beginning in the year the property is placed in service applies only for purposes of calculating the allowable depreciation deduction under the income forecast method. For all other purposes, the general basis rules of sections 1011 and 1016 apply. Thus, in calculating the adjusted basis for determining gain or loss on the sale of income forecast property, participations and residuals are treated as increasing

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[1027] Treas. Reg. section 1.167(a)-3(a).

[1028] Treas. Reg. section 1.167(a)-3(b).

[1029] Sec. 167(g)(6). An election under section 167(g)(8) was available for taxable years beginning after December 31, 2005 and before January 1, 2011 which provided a 5-year amortization period (beginning with the month in which the property was placed in service) for certain musical works and copyrights with respect to musical compositions.

[1030] Sec. 167(g)(7). For property placed in service after October 22, 2004, taxpayers may choose to include participations and residuals in the adjusted basis of the property for the taxable year the property is placed in service.

the taxpayer's basis only when such items are properly taken into account under the taxpayer's method of accounting.[1031]

Alternatively, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid, consistent with the Associated Patentees[1032] decision. This may be done on a property-by-property basis and must be applied consistently with respect to a given property thereafter.

In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.[1033]

The look-back method is applied in any recomputation year by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

8. Recapture rules

Upon disposition of most property used in a business on which depreciation or amortization deductions were taken, the treatment of the resulting gain or loss as ordinary or capital depends on whether there is a net gain or a net loss under section 1231. If the netting of gains and losses results in a net gain, then, subject to the depreciation recapture rules, long-term capital gain treatment results.[1034] If the netting of gains and losses results in a loss, the loss is fully deductible against ordinary income.[1035]

The depreciation recapture rules require taxpayers to recognize ordinary income in an amount equal to all or a portion of the gain realized as a result of the disposition of property.

[1031] For example, in the case of participations or residuals to which sections 404(a)(5) or 404(b)(1) applies, such participations or residuals would not increase the taxpayer's basis until the amount is included in the gross income of the participant.

[1032] *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

[1033] Sec. 167(g)(2). An exception is allowed under section 167(g)(3) for any property with a cost basis of $100,000 or less.

[1034] Sec. 1231(a)(1).

[1035] Sec. 1231(a)(2).

The purpose of the rules is to limit a taxpayer's ability to reduce ordinary income via depreciation deductions and then receive capital gain treatment for the portion of any gain on the disposition of the depreciated property that resulted from the taking of depreciation deductions. There are two regimes that dictate depreciation recapture, sections 1245 and 1250.[1036]

Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed at a gain are known as section 1245 property.[1037] When a taxpayer disposes of section 1245 property, the taxpayer must recapture the gain on disposition of the property as ordinary income to the extent of earlier depreciation or amortization deductions taken with respect to the asset.[1038] Any remaining gain recognized upon the sale of section 1245 property is treated as section 1231 gain.

Depreciable real property, other than that included within the definition of section 1245 property, disposed at a gain is known as section 1250 property.[1039] Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess of post-1969 depreciation allowances over the depreciation that would have been available under the straight-line method.[1040] However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight-line method. Special rules phase out the recapture for certain types of property held over a specified period of time.[1041]

For corporations, the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property.[1042] For individuals, any capital gain that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property is taxed at a maximum rate of 25 percent.

[1036] Cost recovery deductions taken under ACRS (for property placed in service after 1980 and before 1987 (before August 31, 1986, if the taxpayer so elected)) are generally subject to recapture; however, properties are not necessarily classified as section 1245 or 1250 property in the same manner as similar properties placed in service before or after ACRS.

[1037] Sec. 1245(a)(3).

[1038] Sec. 1245(a)(1).

[1039] Sec. 1250(c).

[1040] Sec. 1250(a)(1).

[1041] Sec. 1250(a)(1)(B). The special phaseout rule applies to residential rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k).

[1042] Sec. 291(a)(1).

Recapture rules apply under other cost recovery provisions, including sections 179 and 197. For recapture purposes, an amortizable section 197 intangible is considered to constitute section 1245 property and is subject to its recapture rules.[1043]

Recapture rules also apply to certain business credits. For example, if property eligible for investment tax credits are disposed of, or otherwise ceases to be investment credit property (*e.g.*, casualty loss), before the close of the recapture period (five years), the tax for the year is increased by a recapture percentage.[1044] Advance rehabilitation and certain energy credits and credits related to certain energy property also are subject to recapture provisions. In addition, in determining the amount of gain that is recaptured as ordinary income under section 1245 or section 1250, the amount of an investment credit downward basis adjustment also is treated as a deduction allowed for depreciation.[1045]

9. Statutory recovery periods

While most recovery periods follow historic Treasury guidance, as noted above, the Congress has established statutory recovery periods in certain cases. Table 22 summarizes the recovery periods determined by statute ("statutory recovery period") as well as the recovery period that would otherwise apply ("standard recovery period"). Parenthetical references following the standard recovery periods included in the table refer to the asset class for the property, if applicable, as set forth in Rev. Proc. 87-56.[1046]

Table 22.–Statutory Recovery Periods for Specified Assets[1047]

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Computer software (purchased)[1048] (sec. 167(f)(1))	3 years	5 years[1049]	Permanent

[1043] See. H.R. Rep. 103-213, August 4, 1993, p. 688. The conference report relating to the 1993 legislation enacting section 197 stated: "For purposes of chapter 1 of the Internal Revenue Code, an amortizable section 197 asset is to be treated as property of a character which is subject to the allowance for depreciation provided in section 167."

[1044] Sec. 50(a).

[1045] Sec. 50(c)(4).

[1046] 1987-2 C.B. 674.

[1047] Table 22 includes statutory recovery periods for specified assets that are permanent, or those that expire on or after December 31, 2011.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Mortgage servicing rights (sec. 167(f)(3))	9 years	Varies based on contract length[1050]	Permanent
Geological and geophysical expenditures (sec. 167(h))	2 years (7 years for major integrated oil companies)	Allocated to the cost of the property that was acquired or retained.[1051]	Permanent
Race horses (sec. 168(e)(3)(A)(i))	3 years	3 years (over 2 years old) (01.223)[1052] 7 years (No class life)[1053]	December 31, 2013 (any race horse) Permanent (any race horse over the age of two and that is placed in service after December 31, 2013)
Horses over 12 years old, other than race horses (sec. 168(e)(3)(A)(ii))	3 years	7 years (No class life)[1054]	Permanent

[1048] Software development costs can be deducted currently. Rev. Proc. 69-21, 1969-2 C.B. 303, Rev. Proc. 2000-50, 2000-2 C.B. 601.

[1049] For computer software purchased before August 11, 1993. Rev. Proc. 69-21, 1969-2 C.B. 303.

[1050] In general, mortgage servicing rights would be amortized over the life of the underlying contract (*e.g.*, 30 years for 30-year mortgage).

[1051] For taxable years beginning before August 10, 2005. Rev. Rul. 77-188, 1977-1 C.B. 76. Other special provisions currently in effect may apply absent Sec. 167(h).

[1052] Rev. Proc. 88-22, 1988-1 C.B. 785.

[1053] *Ibid.*

[1054] *Ibid.*

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Qualified rent-to-own property (sec. 168(e)(3)(A)(iii))	3 years	5 years (57.0)[1055]	Permanent
Automobiles or light general purpose trucks (sec. 168(e)(3)(B)(i))	5 years	3 years (00.241)	Permanent
Semi-conductor manufacturing equipment (sec. 168(e)(3)(B)(ii))	5 years	5 years (36.0)	Permanent
Computer-based telephone central office switching equipment (sec. 168(e)(3)(B)(iii))	5 years	10 years (48.12)[1056]	Permanent
Qualified technological equipment (*i.e.*, computers and related peripheral equipment) (sec. 168(e)(3)(B)(iv))	5 years	5 years (00.12) if used in the normal course of business operations. Remaining items are industry specific. [1057]	Permanent

[1055] Rev. Proc. 95-38, 1995-2 C.B. 397. Rev. Rul. 95-52, 1995-2 C.B. 27.

[1056] Rev. Proc. 87-57 refers to the code section in defining the class life.

[1057] Assets that do not fall into Rev. Proc. 87-56 classes 00.11 through 00.4 for depreciable assets used in all business activities must be classified according to classes 01.1 through 80.0 for depreciable assets used in specific business activities. The property would be classified according to the specific business activity in which the property was primarily used. For example, research and development property used in the manufacture of locomotives (class life 37.41) would be recovered over a 7-year period, while research and development property used in the manufacture of sugar and sugar products (class life 20.2) would be recovered over a 10-year period.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Qualified technological equipment (*i.e.*, high technology telephone station equipment) (sec. 168(e)(3)(B)(iv))	5 years	7 years (48.13)	Permanent
Qualified technological equipment (*i.e.*, high technology medical equipment) (sec. 168(e)(3)(B)(iv))	5 years	5 years (57.0)	Permanent
Research and experimentation property (secs. 168(e)(3)(B)(v) and 1245)	5 years	Industry specific[1058]	Permanent
Solar or wind energy property (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(i))	5 years	Industry specific[1059]	Permanent
Fiber-optic solar energy property (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(ii))	5 years	Industry specific[1060]	December 31, 2016

[1058] See footnote 1056 above for further explanation.

[1059] See footnote 1056 above for further explanation.

[1060] See footnote 1056 above for further explanation.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Geothermal energy property (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(iii))	5 years	Industry specific[1061]	Permanent
Fuel cell or qualified microturbine property (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(iv))	5 years	Industry specific[1062]	Permanent
Combined heat and power system property (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(v))	5 years	Industry specific[1063]	Permanent
Qualified small wind energy property (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(vi))	5 years	Industry specific[1064]	Permanent
Thermal energy equipment using ground or ground water (secs. 168(e)(3)(B)(vi) and 48(a)(3)(A)(vii))	5 years	Industry specific[1065]	December 31, 2016

[1061] See footnote 1056 above for further explanation.

[1062] See footnote 1056 above for further explanation.

[1063] See footnote 1056 above for further explanation.

[1064] See footnote 1056 above for further explanation.

[1065] See footnote 1056 above for further explanation.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Railroad tracks (sec. 168(e)(3)(C)(i))	7 years	Unknown[1066]	Permanent
Motorsports racetrack property (secs. 168(e)(3)(C)(ii) and (i)(15))	7 years	15 years (with 150 percent declining balance method) (00.3)[1067] or 39 years (straight-line)	December 31, 2013
Alaska natural gas pipeline (secs. 168(e)(3)(C)(iii) and (i)(16))	7 years[1068]	15 years (with 150 percent declining balance method) (46.0)	Permanent
Natural gas gathering line (sec. 168(e)(3)(C)(iv))	7 years	15 years (with 150 percent declining balance method) (46.0)[1069]	Permanent

[1066] The useful life of this property is unclear.

[1067] See TAM 200526019.

[1068] To depreciate Alaska natural gas pipeline property over seven years, the general rule requires that the assets be placed in service after December 31, 2013. However, Alaska natural gas pipeline property will be treated as placed in service on January 1, 2014 if the taxpayer who places such system in service prior to that date elects such treatment.

[1069] For natural gas gathering lines where the original use of the property commences with the taxpayer before April 12, 2005.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Single purpose agricultural or horticultural structures (*e.g.*, greenhouse specifically designed, constructed and used for the commercial production of plants) (secs. 168(e)(3)(D)(i) and (i)(13))	10 years	20 years (01.3)	Permanent
Tree or vine bearing fruits or nuts (secs. 168(b)(3)(E) and (e)(3)(D)(ii))	10 years (straight-line)	15 years (with 150 percent declining balance method)[1070]	Permanent
Smart electric distribution property (*i.e.*, qualified smart electric grid system and qualified smart electric meter) (sec. 168(b)(2)(C), secs. 168(e)(3)(D)(iii) and (iv), and secs. 168(i)(18) and (19))	10 years (with 150 percent declining balance method)	20 years (with 150 percent declining balance method) (49.14)[1071]	Permanent
Municipal wastewater treatment plant (sec. 168(e)(3)(E)(i))	15 years	20 years (with 150 percent declining balance method) (49.3)	Permanent

[1070] At the time the present law was enacted, it was unclear whether trees and vines were classified as land improvements, recovered over 15 years, or whether they have no class life. H.R. Rep. No. 100-1104, Conference Report to Accompany H.R. 4333, the Technical Corrections and Miscellaneous Revenue Act of 1988, October 21, 1988, pp. 149-150.

[1071] For property placed in service before October 4, 2008.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Telephone distribution plant and comparable equipment used for two-way exchange of voice and data communications (sec. 168(e)(3)(E)(ii))	15 years	15 years (with 150 percent declining balance method) (48.14)[1072]	Permanent
Retail motor fuel outlets (sec. 168(e)(3)(E)(iii))	15 years	15 years (with 150 percent declining balance) (57.1)[1073] or 39 years (straight-line)	Permanent
Qualified leasehold improvements (sec. 168(b)(3)(G) and sec. 168(e)(3)(E)(iv))	15 years (straight-line)	39 years (straight-line)	December 31, 2013
Qualified restaurant property (sec. 168(b)(3)(H) and sec. 168(e)(3)(E)(v))	15 years (straight-line)	39 years (straight-line)[1074]	December 31, 2013
Gas utility land improvements (*i.e.*, initial clearing and grading) (sec. 168(e)(3)(E)(vi)	15 years	7 years[1075] or non-depreciable	Permanent

[1072] A 15 year recovery period is provided for telephone distribution plant and comparable equipment used for two-way voice and data communications. However, a 7 year recovery period (48.42) is provided for cable distribution plant and comparable equipment used for two-way voice and data communications.

[1073] IRS Industry Specialization Program Coordinated Issue Paper, Petroleum and Retail Industries Coordinated Issue: Convenience Stores (before revisions); see S. Rep. No. 281, 104th Cong., 2d Sess. 15 (1996).

[1074] For property placed in service before January 1, 2009.

[1075] Initial clearing and grade improvements were specifically excluded from Asset Class 49.24 under Rev. Proc. 87-56, and no separate asset class was provided for those improvements. Accordingly, the cost of those

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Certain electric transmission property (property used in the transmission of electricity for sale at 69 kilovolts) (sec. 168(e)(3)(E)(vii))	15 years	20 years (with 150 percent declining balance method) (49.14)[1076]	Permanent
Qualified retail improvements (sec. 168(b)(3)(I) and sec. 168(e)(3)(E)(ix))	15 years (straight-line)	39 years (straight-line)	December 31, 2013
Tax exempt use property subject to a lease (sec. 168(g)(3)(A))	Straight-line over a recovery period equal to the longer of the property's class life or 125 percent of the lease term	Varies based on property class life	Permanent
Indian reservation property (sec. 168(j))	Shorter recovery periods than MACRS[1077]	MACRS recovery periods	December 31, 2013
Cellulosic biofuel plant property (sec. 168(l))	50-percent bonus in the first year[1078]	Unknown[1079]	December 31, 2013

improvements was depreciated under MACRS over a seven-year recovery period as assets for which no class life is provided. Certain amounts may be considered nondepreciable land.

[1076] For electric transmission property where the original use of the property commences with the taxpayer before April 12, 2005.

[1077] See section 168(j)(2).

[1078] The property's original use must commence with the taxpayer after December 20, 2006 and it must purchased by the taxpayer after December 20, 2006 (or for self-constructed property if the taxpayer began manufacturing, constructing, or producing the property after December 20, 2006) and no written binding contract for its acquisition was in effect before December 21, 2006.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Reuse and recycling property (sec. 168(m)(1)(A))	50-percent bonus in the first year[1080]	7 years (49.5)	Permanent
Pollution control facilities (secs. 169 and 291)	5 years (7 years for certain atmospheric pollution control facilities)	Industry specific[1081] or 39 years (straight-line)	Permanent
Magazine circulation expenditures (sec. 173)	Deduct currently	Unknown[1082]	Permanent
Research and development expenditures[1083] (sec. 174)	Deduct currently	Industry specific[1084]	Permanent

[1079] The useful life of this property is currently unclear.

[1080] The property's original use must commence with the taxpayer after August 31, 2008 and be purchased by the taxpayer after August 31, 2008 (or for self-constructed property if the taxpayer began manufacturing, constructing, or producing the property after August 31, 2008), but only if no written binding contract for the acquisition was in effect before September 1, 2008.

[1081] See footnote 1056 above for further explanation.

[1082] A three-year election to amortize expenditures is currently allowed under sec. 59(e). Alternatively, the amortization period may be determined under secs. 167 or 197.

[1083] For a more detailed discussion of the tax treatment of research and development expenditures, refer to Joint Committee on Taxation, *Tax Incentives for Research, Experimentation, and Innovation* (JCX-45-11), September 16, 2011. Research and development expenditures do not include property of a character which is subject to the allowance for depreciation or depletion. Sec. 174(b)(1)(C).

[1084] See footnote 1056 above for further explanation. It should be noted that research and development expenditures are deferred until a depreciable asset is created. Once an asset is created and placed in service, the research and development amounts are recovered through depreciation (or deducted at the time such asset is abandoned).

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Soil and water conservation expenditures; endangered species recovery expenditures[1085] (sec. 175)	Deduct currently (not to exceed 25% of annual gross farming income)[1086]	Non-depreciable[1087]	Permanent
Liquid fuel refinery property[1088] (sec. 179C)	50-percent bonus in the first year[1089]	10 years (13.3 or 49.223)	December 31, 2013
Energy efficient commercial buildings deduction (sec. 179D)	Additional deduction of $1.80 per square foot	39 years (straight-line) (with no additional deduction)	December 31, 2013
Advanced mine safety equipment (sec. 179E)	50-percent bonus in the first year	7 years (10.0)	December 31, 2013

[1085] For endangered species recovery expenditures incurred after December 31, 2009.

[1086] Any excess may be carried over and deducted in succeeding taxable years.

[1087] Costs are added to the basis of the land. Treas. Reg. sec. 1.175-1.

[1088] A qualified refinery is any refinery located in the United States that, for property placed in service after August 8, 2005 and on or before October 3, 2008, is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels; or, for property placed in service after October 3, 2008 and before January 1, 2014, is designed to serve the primary purpose of processing liquid fuel from crude oil, qualified fuels, or directly from shale or tar sands.

[1089] For property placed in service after August 8, 2005 that was not subject to a written binding contract to purchase the property in effect before June 15, 2005. If the property is not placed in service before January 1, 2010, there must have been a written binding contract to purchase the property in place before January 1, 2010, or for self-constructed property, construction of the property began after June 15, 2005 and before January 1, 2010.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Fertilizer and soil enrichment costs incurred by farmers (sec. 180)	Deduct currently	Facts and circumstances[1090]	Permanent
Certain qualified film and television productions (sec. 181)	Deduct currently (subject to certain dollar limitations)	Income forecast method	December 31, 2013
Expenditures to remove architectural and transportation barriers to the handicapped and elderly (sec. 190)	Deduct currently (not to exceed $15,000)	39 years (straight-line) or non-depreciable	Permanent
Tertiary injectants (sec. 193)	Deduct currently	Facts and circumstances[1091]	Permanent
Reforestation expenditures (sec. 194)	Deduct currently[1092] or 7 year amortization	Depletion[1093]	Permanent

[1090] Expenditures which affect production for more than one year must be capitalized and recovered over the period for which they impact production.

[1091] Expenditures which affect production for more than one year must be capitalized and recovered over the period for which they impact production.

[1092] Annual expenditures of up to $10,000 may be currently deducted in the year paid or incurred.

[1093] Depletion is the exhaustion of natural resources as a result of production. The deduction is similar to depreciation in that it allows the taxpayer to recover the cost of an asset over the resources' productive life. See sec. 611 and 612.

Provision	Statutory Recovery Period	Standard Recovery Period	Expiration
Environmental remediation costs (sec. 198)	Deduct currently	Unknown[1094]	December 31, 2011
Intangible drilling costs ("IDC") (Secs. 263(c) and 291)	Deduct currently (30 percent of IDCs amortized over 5 years for major integrated oil companies)	Depletion or depreciation (based on the specific applicable recovery period for the depreciable item)[1095]	Permanent
Luxury vehicles (sec. 280F)	Limits the annual deduction	3 years (00.22)	Permanent
Exploration and development costs (secs. 616, 617 and 291)	Deduct currently (30 percent of exploration and development costs amortized over 5 years for corporations)	Depletion[1096]	Permanent

[1094] The capitalization of environmental remediation expenditures under prior law was a question of fact and subject to dispute. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 330, 488 (1997).

[1095] IDCs do not include expenses for items that have a salvage value (such as pipes or casings), items that are part of the acquisition price of an interest in the property, or amounts property allocable to the cost of depreciable property. A taxpayer may elect to deduct IDC ratably over a 60-month period under sec. 59(e). If the taxpayer makes this election, no alternative minimum tax preference amount results.

[1096] Costs are allocated to a specific property unit and depleted under section 611 or 612. Losses incurred on abandoning areas of interest can be deducted under section 165. A taxpayer may elect to deduct exploration and development costs over a 10-year period under section 59(e). If the taxpayer makes this election, no alternative minimum tax preference amount will result.

10. Tax treatment and incentives related to items purchased or produced by the taxpayer

Tax Accounting for Inventory

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[1097] In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

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

Last-in, first-out ("LIFO") inventory method

In general

Under the LIFO method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[1098] Compared to FIFO, LIFO generally produces net income that more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, use of a LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory generally is not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which the quantity of items sold sales exceed purchases.[1099]

[1097] Sec. 471(a) and Treas. Regs. sec. 1.471-1.

[1098] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward as the beginning inventory of the following year. Sec. 472(b).

[1099] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (and inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO

Dollar-value LIFO

One permissible variation of the LIFO method, known as dollar-value LIFO, measures inventory not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the pooling of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer's method for defining an item, LIFO can be applied to a taxpayer's entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.[1100] In doing so, the Congress acknowledged that use of a LIFO method generally is considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.[1101]

To qualify for the simplified method, a taxpayer must have average annual gross receipts of $5 million or less for the three preceding taxable years.[1102] Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.[1103]

Special rules for qualified liquidations of LIFO inventories

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 of the Code mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

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layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

[1100] Sec. 474(a).

[1101] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514),* (JCS-10-87), May 4, 1987, p. 482.

[1102] Sec. 474(c).

[1103] A similar method, the inventory price index computation (often referred to as "IPIC") method, is available to any taxpayer using a LIFO method under Treas. Reg. sec. 1.472-8(e).

Lower of Cost or Market ("LCM") Inventory Method

Treasury regulations provide that taxpayers that maintain inventories under section 471 may determine the value of ending inventory under either the cost method or the lower-of-cost-or-market ("LCM") method.[1104] Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, subnormal goods, defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to bona fide net selling price, under either the cost or LCM method.

Uniform Capitalization ("UNICAP") Rules

As part of the Tax Reform Act of 1986, section 263A was enacted to provide uniform capitalization ("UNICAP") rules for certain property produced, or acquired for resale, by the taxpayer. For real or tangible personal property produced by the taxpayer, section 263A generally requires certain direct and indirect costs (including interest) allocable to such property to be included in either inventory or capitalized into the basis of such property, as applicable.[1105] For real or personal property acquired by the taxpayer for resale, section 263A also generally requires certain direct and indirect costs allocable to such property to be included in inventory.[1106]

For purposes of section 263A, the term "produce" includes construct, build, install, manufacture, develop, or improve.[1107] Further, with respect to property produced for the taxpayer under a contract, the taxpayer is treated as producing the property for purposes of applying the rules under section 263A.[1108]

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;[1109] such taxpayers are not required to include additional section 263A costs in inventory. Another exception exists for taxpayers who raise, harvest, or grow trees.[1110] 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

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[1104] Treas. Reg. sec. 1.471-2(c). Taxpayers valuing their inventory under section 472 (using the LIFO method) must maintain such inventories at cost.

[1105] Sec. 263A(b)(1). See section 263A(f) for rules related to the capitalization of interest.

[1106] Sec. 263A(b)(2).

[1107] Sec. 263A(g)(1).

[1108] Sec. 263A(g)(2).

[1109] Sec. 263A(b)(2)(B).

[1110] Sec. 263A(c)(5).

ornamental trees) and any real property underlying such trees. Free lance authors, photographers, and artists also are exempt from section 263A for any qualified created expenses.[1111] 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.

Long-term contract accounting

Percentage-of-completion method

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[1112] Under such method, the percentage-of-completion is determined by comparing (1) costs allocated to the contract and incurred before the end of the taxable year with (2) the estimated total contract costs. 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. The allocation of costs to a contract is made in accordance with regulations.[1113]

A "long-term contract" is defined as any contract for the manufacture, building, installation, or construction of property when such contract is not completed within the same taxable year as the contract was entered into.[1114] However, a contract to manufacture property shall not be considered a long-term contract unless the contract involves the manufacture of (1) any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or (2) any item which normally requires more than 12 calendar months to complete.[1115]

Exceptions to percentage-of-completion

Two exceptions are provided under section 460 that exempt certain contracts from the requirement to use the percentage-of-completion method to compute taxable income. One such exception is provided for home construction contracts.[1116] A "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property with respect to dwelling units

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[1111] Sec. 263A(h).

[1112] Sec. 460(a).

[1113] Treas. Reg. sec. 1.460-5.

[1114] Sec. 460(f)(1).

[1115] Sec. 460(f)(2).

[1116] Sec. 460(e)(1)(A).

and improvements to real property directly related to (and located on the site of) such dwelling units.[1117]

The second exception from the long-term contract rules is provided for any construction contract of a taxpayer (1) who estimates (at the time such contract is entered into) that such contract will be completed within two years of commencement and (2) whose average annual gross receipts for the prior three taxable years do not exceed $10 million.[1118]

Another exception is provided under section 460 for qualified ship construction contracts and qualified naval ship contracts, which allows such qualifying contracts to be accounted for using the 40/60 percentage-of-completion/capitalized cost method ("PCCM"). Under the 40/60 PCCM, 60 percent of a taxpayer's long-term contract income is exempt from the requirement to use the percentage-of-completion method while 40 percent remains subject to the requirement. The exempt 60 percent of long-term contract income must be reported by consistently using the taxpayer's exempt contract method. Permissible exempt contract methods include the percentage of completion method, the exempt-contract percentage-of-completion method, and the completed contract method.[1119]

Under section 10203(b)(2)(B) of the Revenue Act of 1987,[1120] "qualified ship construction contracts" means any contract for the construction in the United States of not more than five ships if such ships will not be constructed (directly or indirectly) for the Federal government and the taxpayer reasonably expects to complete such contract within five years of the contract commencement date.

Under section 708 of the American Jobs Creation Act of 2004,[1121] "qualified naval ship contracts" are defined as any contract or portion thereof that is for the construction in the United States of one ship or submarine for the Federal Government if the taxpayer reasonably expects the acceptance date will occur no later than nine years after the construction commencement date.

Look-back method

Upon the completion of a long-term contract, a taxpayer must pay interest under the look-back method to the extent that taxes in a prior contract year were underpaid due to the use of estimated contract price and costs rather than the actual contract price and costs.[1122]

[1117] Sec. 460(e)(6).

[1118] Sec. 460(e)(1)(B).

[1119] Treas. Reg. Sec. 1.460-4(c)(1).

[1120] Pub. L. No. 100-203 (1987).

[1121] Pub. L. No. 108-357 (2004).

[1122] Sec. 460(b)(2).

Domestic production activities deduction

Legislative background

Congress both repealed the Extraterritorial Income ("ETI") regime and enacted section 199 as part of the American Jobs Creation Act of 2004.[1123] The ETI regime had been deemed inconsistent with obligations of the United States under various international trade agreements and was repealed to bring the law into compliance with those agreements. The section 199 legislation was crafted to replace the ETI benefit with tax relief designed to be comparable to a three-percentage-point reduction in the tax rate applied to U.S.-based manufacturing. The deduction was phased in over time to match the phase-out of the ETI regime.[1124] As described in 2005:

"The Congress believed that it was appropriate and necessary to replace the ETI regime with provisions that reduce the tax burden on domestic manufacturers, including small businesses engaged in manufacturing. The Congress was of the view that a reduced tax burden on domestic manufacturers [would] improve the cash flow of domestic manufacturers and make investments in domestic manufacturing facilities more attractive."[1125]

Prior to the enactment of section 199 there was no provision in the Code that permitted taxpayers to claim a deduction equal to a percentage of taxable income attributable to their domestic production activities. Congress subsequently modified the statute several times to make additions and corrections to the way the deduction is computed.[1126] A provision was added which allows businesses to claim the section 199 deduction for qualifying activities taking place in Puerto Rico for taxable years beginning after December 31, 2005 and before January 1, 2014.[1127] The section 199 deduction for taxpayers with oil related qualified production related activities income was reduced by three percentage points for taxable years beginning after 2009.[1128] Special rules were put in place for domestic film production for taxable years beginning after December 31, 2007.[1129]

[1123] Pub. L. No. 108-357, sec. 102 (2004).

[1124] For taxable years beginning in 2005 and 2006, the deduction was three percent of such income. For taxable years beginning in 2007, 2008, and 2009, the deduction was six percent of such income.

[1125] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, p. 170.

[1126] See Pub. L. No. 109-135, sec. 403(a) (2005), Pub. L. No. 109-22, sec. 514(a) (2006).

[1127] Pub. L. No. 109-432, sec. 401 (2006). The provision was effective for the first two years beginning after December 2005 and before January 2008. The provision has been extended a number of times and currently expires for taxable years beginning after December 31, 2013.

[1128] Pub. L. No. 110-343, sec. 401(a) (2008).

[1129] Pub. L. No. 110-343, sec. 502 (2008).

Present law

In general

Section 199 of the Code provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the lesser of a taxpayer's taxable income or its qualified production activities income.[1130] For taxable years beginning after 2009, the deduction is nine percent of such income. With respect to a taxpayer that has oil related qualified production activities income for taxable years beginning after 2009, the deduction is limited to six percent of the least of its oil related production activities income, its qualified production activities income, or its taxable income.[1131]

However, a taxpayer's deduction under section 199 for a taxable year may not exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[1132] In the case of corporate taxpayers that are members of certain affiliated groups,[1133] the deduction is determined by treating all members of such groups as a single taxpayer and the deduction is allocated among such members in proportion to each member's respective amount (if any) of qualified production activities income.

Qualified 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 such receipts;[1134]

[1130] In the case of an individual, the deduction is equal to a portion of the lesser of the taxpayer's adjusted gross income or its qualified production activities income. For this purposes, 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.

[1131] Sec. 199(d)(9). "Oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas or any primary product thereof (as defined in section 927(a)(2)(C) prior to its repeal).

[1132] For purposes of the provision, wages include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

[1133] Members of an expanded affiliated group for purposes of the provision generally include those corporations which would be members of an affiliated group if such membership were determined based on an ownership threshold of "more than 50 percent" rather than "at least 80 percent."

[1134] For purposes of determining such costs, any item or service that is imported into the United States without an arm's length transfer price is treated as acquired by purchase, and its cost shall be treated as not less than its value when 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. With regard to property previously 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 re-imported into

(2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[1135]

Domestic production gross receipts

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 that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;[1136] (2) any sale, exchange or other disposition, or any lease, rental, or license, of qualified film produced by the taxpayer; (3) any sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction activities performed in the United States;[1137] or (5) in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States for construction projects located in the United States.[1138]

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the United States after further manufacture. Except as provided by the Secretary, the value of property for this purpose is its customs value (as defined in section 1059A(b)(1)).

[1135] See Treas. Reg. section 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. Where appropriate, such rules are similar to and consistent with relevant present-law rules (*e.g.*, sec. 263A, in determining the cost of goods sold, and sec. 861, in determining the source of such items). Other deductions, expenses or losses that are directly allocable to such receipts include, for example, selling and marketing expenses. A proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income include, for example, general and administrative expenses allocable to selling and marketing expenses. In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction.

[1136] Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer 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 qualifying production property (whether or not by the taxpayer).

[1137] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting that is not performed in connection with activities that otherwise constitute substantial renovation.

[1138] With regard to the definition of "domestic production gross receipts" as it relates to construction performed in the United States and engineering or architectural services performed in the United States for construction projects in the United States, the term refers only to gross receipts derived from the construction of real property by a taxpayer engaged in the active conduct of a construction trade or business, or from engineering or architectural services performed with respect to real property by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business.

However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person.[1139] Further, domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment, that are derived from the transmission or distribution of electricity, gas, and potable water, or that are derived from the lease, rental, license, sale, exchange, or other disposition of land.[1140]

A special rule for government contracts provides that property that is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government is considered to be domestic production gross receipts even if title or risk of loss is transferred to the Federal Government before the manufacture or production of such property is complete to the extent required by the Federal Acquisition Regulation.[1141]

Qualifying production property

Qualifying production property generally includes any tangible personal property, computer software, or sound recordings. Qualified film includes any motion picture film or videotape[1142] (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 such film (including compensation in the form of residuals and participations)[1143] constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.[1144] A qualified film also includes any copyrights, trademarks, or other intangibles with respect to such film. 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.[1145]

Other rules

Partnerships and S corporations.−With respect to the domestic production activities of a partnership or S corporation, the deduction under section 199 is determined at the partner or

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[1139] Sec. 199(c)(7). In general, principles similar to those under the present-law extraterritorial income regime apply for this purpose. See Temp. Treas. Reg. sec. 1.927(a)-1T(f)(2)(i).

[1140] Sec. 199(c)(4)(B).

[1141] Sec. 199(c)(4)(C).

[1142] See Treas. Reg. sec. 1.199-3(k).

[1143] To the extent that a taxpayer has included an estimate of participations and/or residuals in its income forecast calculation under section 167(g), the taxpayer must use the same estimate of participations and/or residuals for purposes of determining total compensation.

[1144] Treas. Reg. sec. 1.199-2.

[1145] Sec. 199(b)(2)(D). Effective for tax years beginning after December 31, 2007.

shareholder level.[1146] In performing the calculation, each partner or shareholder generally will take 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's or shareholder's own qualified production activities, if any.[1147] Each partner or shareholder is treated as having W-2 wages for the taxable year in an amount equal to such person's allocable share of the W-2 wages of the partnership or S corporation for the taxable year.[1148]

Qualifying in-kind partnerships.−In general, an owner of a passthrough entity is not treated as conducting the qualified production activities of the passthrough entity, and vice versa. However, the Treasury regulations provide a special rule for qualifying in-kind partnerships, which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[1149] In the case of a qualifying in-kind partnership, each partner is treated as having manufactured, produced, grown, or extracted property to the extent such property is distributed by the partnership to that partner.[1150] If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was manufactured, produced, grown, or extracted by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the manufacture, production, growth, or extraction activities previously conducted by the qualifying in-kind partnership with respect to that property.[1151]

Trusts and estates.−In the case of a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary under regulations prescribed by the Secretary.[1152]

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

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[1146] Sec. 199(d)(1)(A)(i).

[1147] Sec. 199(d)(1)(A)(ii).

[1148] Sec. 199(d)(1)(A)(iii).

[1149] Treas. Reg. sec. 1.199-9(i)(2).

[1150] Treas. Reg. sec. 1.199-9(i)(1).

[1151] *Ibid*.

[1152] See Treas. Reg. secs. 1.199-5(d) and (e).

horticultural products that are manufactured, produced, grown, or extracted by cooperatives,[1153] or that are marketed through cooperatives, as it provides for qualified production activities income of other taxpayers. That is, the cooperative may claim a deduction from qualified production activities income.

Alternatively, section 199 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. 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). The cooperative cannot reduce its income under section 1382 (*e.g.*, cannot claim a dividends-paid deduction) for such amounts.

Alternative minimum tax.−The deduction for domestic production activities is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

11. Tax treatment and incentives related to research and development expenses

Deduction for Research and Experimental Expenditures

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[1154] Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[1155] Taxpayers, alternatively, may elect to amortize their research

[1153] 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.

[1154] Sec. 174.

[1155] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures either are not deductible or are amortizable over a period of not less than 180 days once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize the section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

expenditures over a period of 10 years.[1156] Generally, such deductions are reduced by the amount of the taxpayer's research tax credit (discussed in more detail below).[1157]

Amounts defined as research and experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to development or improvement of a product.[1158] 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.[1159] 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.[1160] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[1161]

However, generally no current deduction 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.[1162] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[1163]

[1156] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the NOL carryforward regime.

[1157] Sec. 280C(c). Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed. Sec. 280C(c)(3).

[1158] 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.

[1159] Treas. Reg. sec. 1.174-2(a)(1).

[1160] Treas. Reg. sec. 1.174-2(a)(1).

[1161] Treas. Reg. sec. 1.174-2(a)(1). 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.

[1162] Sec. 174(c).

[1163] Sec. 174(d).

Credit for Increasing Research Activities

General rule

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[1164] Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit.

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation commonly is referred to as the university basic research credit.[1165]

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2013.[1166]

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all

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[1164] Sec. 41.

[1165] Sec. 41(e).

[1166] Sec. 41(h).

other taxpayers (so called start-up firms).[1167] In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[1168] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[1169]

Alternative simplified credit

The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[1170] Notwithstanding the limitation for

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[1167] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

[1168] Sec. 41(f)(1).

[1169] Sec. 41(f)(3).

[1170] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described in section A) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[1171] In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.[1172] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Deductions allowed to a taxpayer under section 174[1173] (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[1174] Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[1175]

[1171] Sec. 41(d)(3).

[1172] Sec. 41(d)(4).

[1173] See above for a detailed discussion of section 174.

[1174] Sec. 280C(c).

[1175] Sec. 280C(c)(3).

I. Present Law: Pensions/Retirement

1. Tax-favored employer-sponsored retirement plans

Overview of Employer-Sponsored Tax-Favored Retirement Plans

Whether to provide a tax-favored retirement plan to employees as part of their compensation package is a voluntary choice by an employer, determined in part by the value of the plan to employees. For employers that decide to offer a tax-favored retirement plan, the Code provides rules as to the amount of benefits, the timing of benefit distributions, and the deductibility of contributions. The Code also imposes protections for employees to ensure that they receive the benefits promised under the plan, for example, by requiring defined benefit plans to be adequately funded and protecting the integrity of individual accounts under defined contribution plans by making sure account assets are not misused or diverted; parallel rules generally apply under the Employee Retirement Income Security Act of 1974 ("ERISA"). However, subject to these rules, an employer has a great deal of flexibility in deciding the structure of its retirement plan and the level of benefits, as permitted under the various types of plans available.

The most common type of tax-favored plan is a qualified retirement plan,[1176] which may be a defined benefit plan or a defined contribution plan. A defined contribution plan may include a qualified cash or deferred arrangement ("section 401(k) plan").[1177] Another option is a qualified annuity plan,[1178] which is similar to and subject to requirements similar to those applicable to qualified retirement plans.

Additional options are available to certain tax-exempt or governmental employers, including tax-deferred annuities ("section 403(b) plan")[1179] and governmental eligible deferred compensation plans ("governmental section 457(b) plan"),[1180] which are sometimes offered instead of a section 401(k) plan. Certain employers have the option of maintaining a SIMPLE IRA plan[1181] or a simplified employee pension ("SEP"),[1182] which are funded through direct contributions by the employer to an IRA established for each employee.

[1176] Sec. 401(a).

[1177] Sec. 401(k).

[1178] Sec. 403(a).

[1179] Sec. 403(b).

[1180] Sec. 457(b). Sec. 457(b) provides rules for eligible deferred compensation plans of State or local governments and tax-exempt employers. However, the rules are quite different. In particular, an eligible deferred compensation plan of State or local government is a funded arrangement, similar to a qualified defined contribution plan, whereas an eligible deferred compensation plan of a tax-exempt employer must be unfunded.

[1181] Sec. 408(p).

[1182] Sec. 408(k).

Qualified Retirement Plans and Annuities

A plan of deferred compensation that meets the qualification requirements under the Code (a "qualified retirement plan") is accorded special tax treatment. Employees do not include employer contributions, earnings on contributions, or benefits in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Certain distributions (such as lump sums) can be rolled over to another tax-favored plan with further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee's income.[1183] Contributions to a qualified retirement plan (other than elective deferrals and after-tax contributions) are exempt from FICA tax, as are plan distributions. Pretax contributions are exempt from income tax withholding, and special withholding rules apply to distributions. Contributions to a qualified retirement plan, and earnings thereon, are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied for favorable tax treatment to apply.[1184] Some of these requirements define the rights of plan participants and beneficiaries, such as the minimum participation and vesting requirements. In addition, assets of the plan must be held in a trust or custodial account for the exclusive benefit of plan participants, and prohibited transaction rules (that is, rules prohibiting self-dealing by employers and plan fiduciaries) apply to plan assets.[1185] Some qualified retirement plans are also subject to minimum funding requirements, discussed below.

Under the minimum participation rules, a plan generally cannot delay an employee's participation in the plan beyond the later of completion of one year of service (*i.e.*, a 12-month period with at least 1,000 hours of service) or attainment of age 21.[1186] In addition, a plan cannot exclude an employee from participation on the basis of attainment of a specified age. Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement.

Under the vesting rules, a participant's right to the benefits he or she has accrued under a plan ("accrued benefit") generally must become nonforfeitable after a specified period of service

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[1183] Sec. 404. Under section 4972, an excise tax may apply if contributions in excess of the deduction limits are made.

[1184] In general, for purposes of these requirements, members of controlled groups under section 414(b) or (c) and affiliated service groups under section 414(m) or (o) are treated as a single employer.

[1185] Secs. 401(a)(2) and 4975. Further discussion of the prohibited transaction rules, particularly special rules for ESOPs, is contained in Present Law relating to Debt, Equity and Capital.

[1186] Sec. 410(a).

and at attainment of normal retirement age under the plan.[1187] Benefits under either a defined benefit plan or a defined contribution plan that are attributable to employee contributions must be fully vested at all times. The period of service after which benefits attributable to employer contributions must be vested depends on the type of plan (defined benefit or defined contribution), as discussed below. A plan may provide for vesting earlier than when required, but not later.

The vesting rules also generally prohibit amendments that reduce previously accrued benefits or eliminate optional forms of benefit with respect to previously accrued benefits. Reductions in an employee's rate of accrual under a defined benefit plan, or rate of allocation under a defined contribution plan, due to increasing age generally are also prohibited.

The vesting rules also prohibit distribution of an employee's accrued benefit without consent (an "involuntary" distribution) before the later of the time the participant has attained normal retirement age under the plan or attained age 62. An exception generally allows an involuntary distribution if the present value of the employee's accrued benefit at the time of the distribution is not more than $5,000 ("mandatory cashout").[1188]

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of the Department of Labor ("DOL").[1189] The ERISA rules generally relate to the rights of plan participants and beneficiaries, reporting and disclosure, and the obligations of plan fiduciaries. Some of the provisions of the Code and ERISA that apply to qualified retirement plans are identical or very similar. For example, ERISA includes minimum participation and vesting requirements that parallel those under the Code.

Some qualified retirement plan requirements provide limits on the tax benefits for qualified retirement plans, such as the limit on compensation that may be taken into account for qualified retirement plan purposes ($255,000 for 2013) and limits on contributions, benefits and deductions.[1190] The limits on contributions, benefits and deductions apply separately to defined benefit and defined contribution plans, as discussed below.

Minimum coverage and nondiscrimination requirements[1191] are intended to ensure that a qualified retirement plan covers an employer's rank-and-file employees as well as highly

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[1187] Sec. 411. A plan may specify the plan's normal retirement age but may not specify a normal retirement age later than age 65 or, if later, the fifth anniversary of the time the participant commenced plan participation.

[1188] In determining present value for this purpose, benefits attributable to a rollover to the plan may be disregarded.

[1189] The Pension Benefit Guaranty Corporation has jurisdiction over the defined benefit plan insurance program under Title IV of ERISA. Governmental plans and church plans are generally exempt from ERISA and from the Code requirements that correspond to ERISA requirements.

[1190] Secs. 401(a)(16) and (17), 404 and 415.

[1191] Secs. 401(a)(3) and (4) and 410(b). A qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements, and plans maintained pursuant to collective bargaining agreements

compensated employees, so that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees. For purposes of these requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $115,000 (for 2013).[1192] Special rules apply to plans that primarily benefit key employees (called "top-heavy plans"), discussed below.

Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees; (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test, which requires the plan to cover a reasonable classification of employees and compares the benefits received by highly compensated employees and nonhighly compensated employees. Under the average benefits test, the plan must also cover a group of employees that is reasonable and established under objective business criteria ("reasonable classification requirement"), and the plan's ratio percentage must meet a specific standard under the regulations. In applying the minimum coverage rules, employees who have not satisfied the minimum age and service conditions under the plan, certain nonresident aliens, and certain collectively bargained employees are generally disregarded in applying the minimum coverage rules.

Under a general nondiscrimination requirement, a qualified retirement plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits. It is generally not discriminatory to provide the same rate of employer contributions or accruals, expressed as a percentage of compensation (up to $255,000 for 2013), to highly compensated and nonhighly compensated employees.

Treasury regulations provide detailed rules for determining whether a plan satisfies the general nondiscrimination requirements.[1193] Under the regulations, the amount of contributions or benefits provided under the plan, and the benefits, rights and features offered under the plan must all be tested to ensure they are not discriminatory. There are three general approaches to testing the amount of benefits under qualified plans: (1) design-based safe harbors under which the plan's benefit or allocation formula satisfies certain uniformity standards; (2) a general test; and (3) cross-testing of equivalent accruals or allocations.[1194]

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are generally deemed to satisfy the nondiscrimination requirements. Under section 403(b)(1)(D) and (b)(12), the nondiscrimination requirements generally apply to a section 403(b) plan of a nongovernmental tax-exempt employer (other than a church).

[1192] Sec. 414(q). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees.

[1193] Treas. Reg. secs. 1. 401(a)(4)-1 through 13.

[1194] Elective deferrals, matching contributions, and after-tax employee contributions to a defined contribution plan are subject to special testing rules as discussed below.

The general test is generally satisfied by measuring the rate of accrual (under a defined benefit plan) or rate of allocation (under a defined contribution plan) of each highly compensated employee to determine if the group of employees with the same or higher rate of accrual or allocation is a nondiscriminatory group.[1195] This test generally is satisfied if the ratio percentage of highly compensated and nonhighly compensated employees with the same or a higher allocation rate or accrual rate as the rate of the highly compensated employee satisfies the minimum coverage requirements (using, if the ratio percentage is less than 70 percent, a simplified nondiscrimination standard which includes disregarding the reasonable classification requirement, but requires satisfaction of the average benefit percentage test).

Cross-testing involves the conversion of allocations or accruals to actuarially equivalent accruals or allocations, with the resulting equivalencies tested under the general test. Cross-testing of allocations under a defined contribution plan is permitted only if certain threshold requirements are satisfied.

Each benefit, right or feature offered under the plan generally must be available to a group of employees that has a ratio percentage that satisfies the minimum coverage requirements including the reasonable classification requirement if applicable, except that the average benefit percentage test does not have to be met, even if the ratio percentage is less than 70 percent.

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. If a plan fails to meet the qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules. Certain rules relating to qualified retirement plans are enforced through an excise tax rather than through disqualification. For example, plan contributions in excess of the deductible limits do not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

Qualified annuity plans are generally subject to the same requirements as qualified retirement plans and receive comparable tax-favored treatment. However, plan assets are invested in annuity contracts rather than held in a trust or custodial account.

[1195] An employee's allocation rate generally is the amount of employer contribution allocated to an employee's account for the plan year, expressed as a percentage of the employee's compensation for the plan year. An employee's accrual rate generally is the amount of the annual payments under the employee's accrued benefit payable at normal retirement age (or other testing age prescribed under the regulations) in the form of a straight life annuity divided by the employee's years of service and expressed as a percentage of average annual compensation. Allocation and accrual rates are then permitted to be increased by a factor to reflect the employer paid portion of social security taxes or benefits (referred to as "permitted disparity). If the defined benefit plan provides subsidized optional forms of benefit, the accrual rate for the most valuable benefit under the plan available to each employee is also calculated and tested.

Types of Qualified Retirement Plans

Defined benefit and defined contribution plans

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contribution plans, based on the nature of the benefits provided.[1196] Although both types of plans are subject to the qualification requirements, the requirements differ somewhat for the two types of plans.

Under a defined benefit plan, benefits are determined under a plan formula, generally based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

Under a defined contribution plan, a separate account is maintained for each participant, to which contributions are allocated and investment earnings (and losses) are credited. A participant's benefits are based solely on the participant's account balance.

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance.

Single-employer, multiple-employer and multiemployer plans

Qualified retirement plans are also categorized by the number of employers that maintain the plan and the type of employees covered by the plan.

A single-employer plan is a plan maintained by one employer; members of controlled groups and affiliated service groups are treated as one employer for this purpose. A single-employer plan may cover employees who are also covered by a collective bargaining agreement ("collectively bargained employees"), pursuant to which the plan is maintained (a "collectively bargained plan").[1197] An employer may maintain separate plans for collectively and noncollectively bargained employees, or they may be covered by the same plan.

A multiple-employer plan is a single plan in which two or more unrelated employers (that is, not members of the same controlled group or affiliated service group) participate.[1198]

[1196] Some qualified retirement plan requirements apply to "pension" plans, which include defined benefit plans and money purchase pension plans, a type of defined contribution plan discussed below. See Treas. Reg. sec. 1.401-1(b)(1)(i) for the definition of pension plan.

[1197] See, *e.g.,* Treas. Reg. sec. 1.410(b)-6(d).

[1198] Sec. 413(c).

Multiple-employer plans are commonly maintained by employers in the same industry, and, more recently, are used by professional employer organizations ("PEOs") to provide qualified retirement plan benefits to employees working for PEO clients.[1199] Some qualification requirements are applied to a multiple-employer plan on a plan-wide basis. For example, all employees covered by the plan are treated as employees of all employers participating in the plan for purposes of the exclusive benefit rule. Similarly, an employee's service with all participating employers is taken into account in applying the minimum participation and vesting requirements, and compensation with all participating employers is taken into account in applying limits on benefits and contributions. Other requirements are applied separately, including the minimum coverage requirements, nondiscrimination requirements (both the general requirements and the special tests for section 401(k) plans) and the top-heavy rules.

Multiemployer plans (also known as "Taft-Hartley" plans, and distinct from multiple-employer plans) are maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers and to which the employers are required to contribute under the collective bargaining agreement(s).[1200] Multiemployer plans commonly cover collectively bargained employees in a particular industry. A multiemployer plan is not operated by the contributing employers; instead, it is governed by a board of trustees ("joint board") consisting of labor and employer representatives.

IRS Administrative Programs

Preapproved plans

The IRS office responsible for qualified retirement plan oversight, the Employee Plans Division of the Tax-Exempt & Government Entities Operating Division, has established an extensive program under which banks, insurance companies, and similar institutions ("service providers") can obtain advance IRS approval of standardized qualified retirement plan documents ("preapproved plans") that can be adopted by employers without each employer having to retain its own legal professionals to draft plan documents for the employer.[1201] A service provider offering a preapproved plan document generally also offers plan-related services, such as holding and managing plan assets, plan record-keeping, participant notices and distributions, and annual reporting to the IRS, DOL and the PBGC. The preapproved plan program helps to make adopting and maintaining a qualified retirement plan more affordable for employers, especially smaller employers.

[1199] Rev. Proc. 2003-86, 2003-2 C.B. 1211, and Rev. Proc. 2002-21, 2002-1 C.B. 911, address the application of the multiple-employer plan rules to defined contribution plans maintained by PEOs.

[1200] Sec. 414(f).

[1201] See Rev. Proc. 2011-49, 2011-44 I.R.B. 608, for background on the preapproved plan program. Under the program, preapproved plans include master and prototype and volume submitter plans.

Group trusts

Under longstanding IRS guidance, the assets of qualified retirement plans maintained by different, unrelated employers can be pooled and held by a "group trust," thus enabling employers of various sizes to benefit from economies of scale for administrative and investment purposes.[1202] In addition to qualified retirement plan assets, a group trust may also hold assets associated with other tax-favored retirement arrangements, including section 403(b) plans, governmental section 457(b) plans, and IRAs.

Employee Plans Compliance Resolution System

Because of the complexity of the requirements for qualified retirement plans, errors in plan documents, as well as plan operation and administration commonly occur. Under a strict application of these requirements, such an error would cause a plan to lose its tax-favored status, the consequences of which would fall most heavily on plan participants. To avoid this result, the IRS has established the Employee Plans Compliance Resolution System ("EPCRS"), which permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.[1203]

EPCRS has three components, providing for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program ("SCP") generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program ("VCP") permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("Audit CAP") provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

Single-employer plans, multiple-employer plans and multiemployer plans are eligible for EPCRS. However, no specific correction methods or procedures have been provided to address the special structures of multiple-employer and multiemployer plans.

Taxation of Distributions

In general

Distributions from qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans are generally includible in gross income (to the extent the

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[1202] Rev. Rul. 81-100, 1981-1 C.B. 326, most recently modified by Rev. Rul. 2011-1, 2011-2 I.R.B. 251, and Notice 2012-6, 2012-3 I.R.B. 293.

[1203] Since establishing the program, the IRS has regularly updated and expanded it. The current program is described in Rev. Proc. 2013-12, 2013-4 I.R.B. 313.

distribution is not a recovery of basis) as ordinary income in the year in which distributed unless the distribution is a qualified distribution from a designated Roth account (discussed below).[1204] The part of any distribution that represents the participant's investment in the contract (*i.e.*, basis) is not includible in gross income. A participant generally has basis under the plan to the extent that the participant has made after-tax contributions to the plan that have not been recovered. The basis recovery rules differ depending on whether or not the distribution is received as an annuity payment.

As discussed below, an additional 10-percent tax applies to distributions before age 59½ from qualified retirement plans and annuities and section 403(b) plans unless an exception applies. In addition, participants in qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans are required to begin receiving distributions at the later of age 70½ or retirement.

Net unrealized appreciation

If employer securities are distributed by a qualified retirement plan and either the distribution is a lump sum distribution or the employer securities are attributable to after-tax employee contributions, the net unrealized appreciation in the securities is excluded from the recipient's gross income.[1205] Net unrealized appreciation is defined as the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to the trust. In other words, it is the amount by which the value of the securities increased while held by the qualified retirement plan. The basis of the employer securities after distribution does not include the amount of net unrealized appreciation excluded from gross income.[1206]

The exclusion for net unrealized appreciation is not available when the distribution is rolled over into another eligible retirement plan. When the securities are received as part of a lump sum distribution, the recipient may elect not to exclude net unrealized appreciation.

Rollovers

A distribution from a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to another such plan or an IRA. The rollover generally can be achieved by direct rollover (direct payment from

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[1204] Secs. 72, 402(a)(1), 402A(d)(1), 403(a)(1), 403(b)(1) and 457(a).

[1205] Section 402(e)(4). Under section 402(e)(4)(E), for purposes of this exclusion for net unrealized appreciation, employer securities include shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form including of a parent or subsidiary of the employer. See section 402(e)(4)(D) for the definition of a lump sum distribution.

[1206] Under Treas. Reg. sec. 1.402(a)-1(b)(1), when employer securities with net unrealized appreciation are sold or exchanged, any gain is treated as long-term capital gain up to the amount of the net unrealized appreciation (regardless of how long the securities were held by the taxpayer). Any gain in excess of the amount of net unrealized appreciation is long-term or short-term gain, depending on how long the taxpayer held the securities after distribution.

the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover"). Amounts that are rolled over are usually not included in gross income. Generally, any distribution of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.[1207]

Any distribution to a beneficiary other than the participant's surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.[1208]

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.[1209] If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20 percent income tax withholding.[1210] Participants 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 withheld will remain taxable unless the participant substitutes funds within the 60 day period.[1211] The direct rollover and 20-percent withholding rules are designed to encourage tax-free rollovers, and thereby, to keep retirement funds in eligible retirement plans.

Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA. Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account (discussed below) must be included in gross income.

[1207] Section 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k).

[1208] Sec. 402(c)(11).

[1209] Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cashout of more than $1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

[1210] Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

[1211] For example, if an employee receives an eligible rollover distribution of $10,000 and elects to have the entire amount paid directly to him, he will receive $8000 since $2000 would have been withheld as income tax. If, within 60 days of receiving the distribution, the employee decides to roll over the distribution into an IRA, he will need to contribute an additional $2000 to the IRA in order to defer taxes on the entire distributed amount.

Owner-Employees

In general

Qualified retirement plans are required to be maintained for the exclusive benefit of employees. Depending on the entity structure used for a business, business owners may be employees or self-employed. In the case of a corporation, including an S corporation, business owners are employees. In the case of a sole proprietorship or partnership, business owners are self-employed. However, for qualified retirement plan purposes, self-employed individuals are treated as employees.[1212]

Although the qualified retirement plan rules generally apply to self-employed individuals in the same manner as to employees, special rules apply in determining the compensation of a self-employed individual and the deduction for plan contributions to provide the self-employed individual with contributions or benefits under the plan.

For qualified retirement plan purposes, a self-employed individual's compensation ("earned income") is net earnings from self-employment as defined for Self-Employed Contributions Act ("SECA") purposes, with certain adjustments.[1213] For example, the contributions made to a qualified retirement plan to provide the self-employed individual with contributions or benefits under the plan (the "self-employed deduction") are not deductible for SECA purposes. However, the deduction does apply in calculating earned income, thus reducing the compensation used to determine contributions or benefits for the self-employed individual under the plan. In addition, if a self-employed individual has more than one trade or business, only earned income from the trade or business with respect to which the plan is maintained may be taken into account under the plan.

Subject to limits, an employer, including a self-employed individual, may deduct as business expenses contributions made to a qualified retirement plan to provide contributions or benefits for employees participating in the plan. In the case of a defined contribution plan, the limit is generally 25 percent of the employees' total compensation. The deduction for these contributions is in addition to any deduction for the employees' compensation used to determine their contributions or benefits. However, because the self-employed deduction reduces the self-employed individual's earned income, the amount that can be deducted is also reduced. For example, depending on the rate of contributions under a defined contribution, the self-employed deduction may be limited to 20 percent of net earnings from self-employment, rather than the 25-percent general limit.

[1212] Sec. 401(c)(1).

[1213] Sec. 401(c)(2), referring to sec. 1402(a). Under section 1402(a), net earnings from self-employment are generally the individual's gross income from a trade or business minus deductions attributable to the business.

Top-heavy rules

Top-heavy rules apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees.[1214] Whereas the general nondiscrimination requirements (described above) are designed to test annual contributions or benefits for highly compensated employees, compared to those of nonhighly compensated employees, the top-heavy rules test the portion of the total plan contributions or benefits that have accumulated for the benefit of key employees as a group. If a plan is top-heavy, minimum contributions or benefits for nonkey employees and, in some cases, faster vesting is required.

For this purpose, a key employee is an officer with annual compensation greater than $165,000 (for 2013), a five-percent owner, or a one-percent owner with compensation in excess of $150,000. A defined benefit plan generally is top-heavy if the present value of cumulative accrued benefits for key employees exceeds 60 percent of the cumulative accrued benefits for all employees. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees. The nature of the top-heavy test is such that a plan of a large business with many employees is unlikely to be top-heavy. The top-heavy requirements are therefore viewed as primarily affecting plans of smaller employers in which the owners participate.

Tax Credit for Small Employer Pension Plan Start-Up Costs

Present law provides a nonrefundable income tax credit for qualified start-up costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or SEP, provided that the plan covers at least one nonhighly compensated employee.[1215] Qualified start-up costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit is the lesser of $500 per year or 50 percent of the qualified start-up costs. The credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, the preceding year.

An eligible employer is an employer that, for the preceding year, had no more than 100 employees with compensation of $5,000 or more. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of controlled groups and affiliated service groups are treated as single employers for purposes of these requirements.

[1214] Secs. 401(a)(10)(B) and 416.

[1215] Sec. 45E.

Saver's Credit

Present law provides a nonrefundable tax credit for eligible taxpayers who make qualified retirement savings contributions.[1216] Subject to adjusted gross income ("AGI") limits, the credit is available to individuals who are 18 or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return. The AGI limits for 2013 (as indexed for inflation) are $59,000 for married taxpayers filing joint returns, $44,250 for head of household taxpayers, and $29,500 for single taxpayers and married taxpayers filing separate returns.

For purposes of the credit, qualified retirement savings contributions include (1) elective deferrals to a section 401(k) plan, a section 403(b) plan, a governmental section 457 plan, a SIMPLE IRA, or a SEP; (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a qualified retirement plan or annuity or a section 403(b) plan. The maximum amount of qualified retirement savings contributions taken into account for purposes of the credit is $2,000. 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 plan or IRA to which eligible contributions can be made during the taxable year for which the credit is claimed, the two taxable years prior to the year 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 for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

The credit is a percentage of the taxpayer's qualified retirement savings contributions up to $2,000. The credit percentage depends on the AGI of the taxpayer, varying from 10 percent to 50 percent, as shown in the table below. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability.

Table 23.–Credit Rates for Saver's Credit (for 2013)

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0 – $35,500	$0 – $26,625	$0 – $17,750	50 percent
$35,501 – $38,500	$26,626 – $28,875	$17,751 – $19,250	20 percent
$38,501 – $59,000	$28,876 – $44,250	$19,251 – $29,500	10 percent

[1216] Sec. 25B.

2. Defined contribution plans

General Description and Rules

As described above, benefits under a defined contribution plan are based solely on the contributions, earnings, and losses credited to the separate accounts maintained for plan participants. For defined contribution plans, a participant's accrued benefit is the participant's account balance. Accordingly, the participant benefits from investment gains and bears the risk of investment losses on the account.

A defined contribution plan may provide for various types of contributions by employees or the employer. In the case of a section 401(k) plan, employees may elect to have pretax contributions made to the plan, referred to as elective deferrals, rather than receive the same amount as current compensation. A section 401(k) plan may also allow employees to designate some or all of their elective deferrals as after-tax Roth contributions. A defined contribution plan may also allow employees to make other after-tax contributions. Possible employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions and can relate to pretax elective deferrals, designated Roth contributions, or other after-tax contributions.

The total contributions made to an employee's account for a year cannot exceed the lesser of $51,000 (for 2013) or the employee's compensation.[1217] Contributions made to more than one plan for an employee are aggregated for purposes of this limit, and employee contributions to a defined benefit plan, if any, are taken into account in applying the limit. However, catch-up contributions (discussed below) are not taken into account in applying the limit.

A defined contribution plan can use one of two alternative minimum vesting schedules with respect to the portion of a participant's account balance that is attributable to employer contributions, including investment returns on employer contributions. Under the first vesting schedule, the account balance attributable to employer contributions must be 100 percent vested upon completion of no more than three years of service (often referred to as "three-year cliff vesting"). Under the second vesting schedule (referred to as "graduated vesting"), the participant's account balance attributable to employer contributions must become vested at a rate of no less than 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period from two to six years of service.

Defined contribution plans often provide for loans to participants, subject to certain conditions, discussed below. Defined contribution plans generally provide for distributions on severance from employment and, depending on the type of plan, may provide for distributions before severance from employment ("in-service" distributions). Defined contribution plans may provide for distributions to be made in a lump sum or installments. Defined contribution plans

[1217] Sec. 415(c).

may also provide for distributions in the form of a life annuity (through the purchase of an annuity contract), but generally are not required to provide annuity distributions.

The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation. For this purpose, a participant's compensation in excess of $255,000 (for 2013) is not taken into account. Elective deferrals (including designated Roth contributions) and employee contributions are not counted in applying the 25-percent limit. Special deduction rules apply to an employee stock ownership plan ("ESOP") (discussed below), or if an employer maintains both a defined contribution plan and a defined benefit plan.

As mentioned above, defined contribution plans are subject to the nondiscrimination rules, *i.e.*, the rules prohibiting discrimination in favor of highly compensated employees as implemented under regulations. Special testing rules apply to section 401(k) plans, discussed below.

General Types of Defined Contribution Plans

Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. The type of plan must be specified in the plan document.

Profit-sharing plans were originally intended as a means of enabling employees to share in the profits of the employer's business. However, under present law, contributions to a profit-sharing plan are permitted regardless of whether the business has profits. A profit-sharing plan may provide for regular employer contributions each year or may provide that contributions are made each year at the discretion of the employer (called a "discretionary" profit-sharing plan). A profit-sharing plan must provide a definite formula under which contributions are allocated to participant accounts and must specify the events upon which distributions will be made to participants, such as severance from employment.

A stock bonus plan is similar to a profit-sharing plan except that benefits are distributable in stock of the employer. The plan may provide for cash distributions, but must also allow participants to take distributions in the form of employer stock. In the case of employer stock that is not publicly traded, participants generally must be given the right to require the employer to repurchase the stock under a fair valuation formula.

A money purchase pension plan must provide for a set level of required employer contributions, generally as a specified percentage of participants' compensation. A money purchase pension plan is subject to the minimum funding requirements, and the employer is generally subject to an excise tax if it fails to make the contributions required under the plan. A money purchase pension plan may not provide for in-service distributions except at normal retirement age (or age 62, if earlier) or in the case of plan termination.

Certain spousal protections apply to qualified retirement plans.[1218] In the case of a pension plan (that is, a money purchase pension plan or a defined benefit plan), these protections generally require that benefits be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant elects a different form of distribution and the participant's spouse consents in writing to the election. A QJSA is generally a life annuity for the participant with an annuity of at least 50 percent of the participant's annuity amount payable to the surviving spouse after the participant's death. If a married participant dies before benefits begin, the plan must offer a survivor benefit for the spouse in the form of a qualified preretirement survivor annuity ("QPSA"), which is a survivor annuity for the spouse that is at least 50 percent of the employee's accrued benefit.

Profit-sharing plans and stock bonus plans are generally not subject to these spousal protection requirements unless the participant elects an annuity form of distribution. However, a profit-sharing or stock bonus plan must provide that a participant's entire vested account balance under the plan will be paid to the participant's surviving spouse unless the spouse consents in writing to a different beneficiary.

Within the three general types of defined contribution plans are plan designs that contain special features, such as a section 401(k) plan or an ESOP, discussed below. In addition, special types of plans are available to certain governmental and tax-exempt employers.

Section 401(k) Plans

In general

A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement.[1219] Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements.

As described above, an employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an employee for a year is $17,500 (for 2013) or, if less, the employee's compensation.[1220] An employee who will attain age 50 by the end of the year may also make catch-up contributions to a section 401(k) plan.[1221] As a result, the dollar limit on elective deferrals is increased by $5,500 (for 2013) for an individual who has attained age 50. An employee's elective deferrals must be fully vested.

[1218] Sec. 401(a)(11).

[1219] Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. In addition, certain small employers may adopt a SIMPLE section 401(k) plan similar to a SIMPLE IRA plan discussed below. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

[1220] Sec. 402(g).

[1221] Sec. 414(v).

Elective deferrals, and attributable earnings, generally cannot be distributed from the plan before the earliest of the employee's severance from employment, death, disability or attainment of age 59½ or termination of the plan. Subject to certain conditions, elective deferrals, but not associated earnings, can be distributed in the case of hardship.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that are not designated Roth contributions. Designated Roth contributions are generally treated the same as any other elective deferral for certain purposes, including the restrictions on distributions discussed above.

Qualified distributions from a designated Roth account are excluded from income, even though they include earnings not previously taxed. A qualified distribution is a distribution made after the end of a specified period (generally five years after the participant's first designated Roth contribution) and that is (1) made on or after the date on which the participant attains age 59½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

A section 401(k) plan that includes a designated Roth program may permit participants to transfer amounts from a nonRoth account under the plan to a designated Roth account, whether or not the amounts in the nonRoth account are permitted to be distributed from the plan at the time of the transfer.[1222] In effect, this transfer is a Roth conversion (with related income recognition) for all nonRoth amounts within the plan.

Section 401(k) plans are not required to provide for matching contributions, but often do. Many employers provide matching contributions because doing so encourages lower-paid employees to make elective deferrals, which makes it easier for the plan to satisfy the applicable nondiscrimination rules. A section 401(k) plan may also provide for employer nonelective contributions.

Automatic enrollment

Section 401(k) plans are generally designed so that the employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the section 401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (*i.e.*, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

[1222] Prior to 2013, such transfers of nonRoth amounts to a designated Roth account were only permitted for amounts that were permitted to be distributed from the plan at the time of the transfer.

Under a section 401(k) plan, an employee must have an effective opportunity to elect to receive cash in lieu of contributions. Whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.[1223]

Automatic enrollment was originally authorized by IRS guidance[1224] and has been furthered by subsequent statutory changes providing special rules for automatic enrollment.[1225] These rules include a nondiscrimination safe harbor (discussed further below) for a section 401(k) plan that includes a qualified automatic contribution arrangement. In addition, if a section 401(k) plan includes an eligible automatic contribution arrangement, elective deferrals that were automatically contributed to the plan (*i.e.*, without an affirmative deferral election by an employee) may be distributed to the employee in accordance with an election by the employee within 90 days after the first automatic contribution.[1226] Such a distribution is permitted, despite the general restriction on in-service distributions of elective deferrals, and the amount distributed is not subject to the 10-percent early withdrawal tax.

Use of these special rules is generally predicated on automatic contributions at a uniform rate (as a percentage of compensation) for all participants. In addition, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment, and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.

Special nondiscrimination tests for section 401(k) plans

General rule

A special annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to elective deferrals under a section 401(k) plan.[1227] The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within

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[1223] Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

[1224] Rev. Rul. 2000-8, 2000-7 I.R.B. 617; Rev. Rul. 2000-33, 2000-31 I.R.B. 142; Rev. Rul. 2000-35, 2000-31 I.R.B. 138; and Treas. Reg. sec. 1.401(k)-1(a)(3)(ii).

[1225] The Pension Protection Act of 2006 ("PPA"), Pub. L. No. 109-280, added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans. The Code rules generally apply also to section 403(b) plans and governmental section 457(b) plans.

[1226] Sec. 414(w).

[1227] Sec. 401(k)(3).

limits: (1) the average deferral rate for highly compensated employees can be up to 125 percent of the average deferral rate for nonhighly compensated employees; or (2) the average deferral rate for highly compensated employees can be two percentage points greater than the average deferral rate for nonhighly compensated employees or, if less, twice the average deferral rate for nonhighly compensated employees. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or "ACP test") which compares the average rate of matching and after-tax contributions to the plan of the two groups.[1228]

If the ADP test is not satisfied, a mechanism is provided for the employer to make immediately vested additional contributions for nonhighly compensated employees (and certain other corrections) or to distribute deferrals of highly compensated employees to such employees, so that the ADP test is satisfied. Similar correction mechanisms apply for purposes of satisfying the ACP test.

Design-based safe harbor nondiscrimination tests

There are also designed-based safe harbor methods of satisfying the ADP and ACP tests.[1229] Under one safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement.[1230] A plan generally satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan. The matching contribution requirement under the safe harbor is 100 percent of elective contributions of the employee for contributions not in excess of three percent of compensation, and 50 percent of elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contribution must be immediately nonforfeitable (*i.e.*, 100 percent vested) when made. Other requirements also apply, including requirements for satisfying the ACP test on a safe harbor basis.[1231]

Another safe harbor applies for section 401(k) plans that include a qualified automatic contribution arrangement.[1232] Under a qualified automatic contribution arrangement, unless an

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[1228] Sec. 401(m)(2).

[1229] Under section 401(k)(11) and (m)(10), a section 401(k) plan that meets requirements similar to those applicable to SIMPLE IRA plans, discussed below, is also deemed to satisfy the nondiscrimination requirements.

[1230] Sec. 401(k)(12). The plan satisfies the notice requirement if, within a reasonable time before the beginning of the plan year, the plan provides written notice to each eligible employee of the employee's rights and obligations under the plan.

[1231] Sec. 401(m)(11).

[1232] Secs. 401(k)(13) and (m)(12).

employee elects otherwise, the employee is treated as electing to make elective deferrals equal to a percentage of compensation as stated in the plan, not in excess of 10 percent and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter.[1233] Under the safe harbor, the matching contribution requirement is 100 percent of elective contributions of the employee for contributions not in excess of one percent of compensation, and 50 percent of elective contributions for contributions that exceed one percent of compensation but do not exceed six percent (for a total matching contribution of up to 3.5 percent of compensation). The rate of the safe harbor nonelective contribution is three percent, as under the regular safe harbor. However, under a qualified automatic contribution arrangement, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service (rather than being immediately vested).

Employee Stock Ownership Plans ("ESOPs")[1234]

In general

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in stock of the employer, referred to as "qualifying employer securities."[1235] An ESOP can be maintained by either a C corporation or an S corporation.[1236] For purposes of ESOP investments, a "qualifying employer security" is generally defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

An ESOP can be an entire plan or it can be a portion of a defined contribution plan. An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a section 401(k) feature that

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[1233] These automatic increases in default contribution rates are required for plans using the safe harbor. Rev. Rul. 2009–30, 2009-39 I.R.B. 391, provides guidance for including automatic increases in other plans using automatic enrollment, including under a plan that includes an eligible automatic contribution arrangement.

[1234] Additional discussion of ESOPs is contained in Present Law relating to Debt, Equity and Capital.

[1235] Sec. 4975(e)(7). Participant accounts in other types of defined contribution plans can also be invested in employer stock.

[1236] A C corporation is so named because its tax treatment is governed by subchapter C of the Code. An S corporation is so named because its tax treatment is governed by subchapter S of the Code. An S corporation is a passthrough entity for income tax purposes. That is, income tax does not apply at the S corporation level. Rather, items of income, gain, or loss are taken into account for tax purposes by the S corporation shareholders on their own tax returns.

permits employees to make elective deferrals. ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. For example, voting rights must generally be passed through to ESOP participants, employees must generally have the right to receive benefits in the form of stock, and certain ESOP participants must be given the right to diversify a portion of their plan benefits (discussed further below).

Certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer stock. Under an exception to the prohibited transaction rules, an employer maintaining an ESOP may lend money to the ESOP, or the employer may guarantee a loan made by a third-party lender to the ESOP, to finance the ESOP's purchase of employer securities.[1237] An ESOP that borrows funds to acquire employer securities is generally called a leveraged ESOP.

In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (which generally limit the deduction for contribution to a defined contribution plan for a year to 25 percent of the participants' compensation) but the limit is applied separately to the payments of principal.[1238] Further, interest payments on the ESOP loan are deductible without regard to the limitation.[1239] In addition, a C corporation may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participants' election.[1240] This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans.

ESOPs maintained by S corporations are subject to special rules. Generally, if a tax-exempt entity, including a trust holding qualified retirement plan assets, holds S corporation stock, it is treated as holding an interest in an unrelated trade or business and is subject to

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[1237] Sec. 4975(d)(3). To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan, the interest on the loan must be at a reasonable rate, and any collateral given to a disqualified person by the plan must consist only of qualifying employer securities.

[1238] Sec. 404(a)(9)(A). An employer can deduct contributions to the plan to pay the principal on an ESOP acquisition loan up to an amount equal 25 percent of employees' compensation and also deduct other contributions that are not being used to pay principle or interest on the loan up to an amount equal to 25 percent of employees' compensation. See Private Letter Ruling 200732028, August 10, 2010.

[1239] Sec. 404(a)(9)(B).

[1240] Sec. 404(k). If a dividend is paid with respect to stock allocated to a participant's account and is used to make a payment on an ESOP loan, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant. Distributions with respect to S corporation stock held in an ESOP may also be used to repay an ESOP loan under similar conditions, but the distribution is not deductible by the S corporation.

unrelated business income tax ("UBIT").[1241] However, an ESOP holding employer securities issued by an S corporation is exempt from UBIT.

In part to prevent interests in income attributable to employer stock of an S corporation held by an ESOP (and thus not subject to current taxation) from being concentrated in a small group of persons, a number of adverse tax consequences may apply if a "nonallocation year" occurs with respect to an ESOP maintained by an S corporation. If any "disqualified person" has an interest in the S corporation in the form of "synthetic equity"[1242] during a nonallocation year, an excise tax is imposed on the S corporation equal to 50 percent of the amount of such synthetic equity. If there are "prohibited allocations"[1243] for the benefit of disqualified persons during a nonallocation year, the amount of the prohibited allocations is treated as distributed to the disqualified persons; an excise tax equal to 50 percent of the amount of the prohibited allocation applies to the S corporation; the qualified plan ceases to be an ESOP; and there is a potential for disqualification of the plan.

A "nonallocation year" is a plan year of an ESOP maintained by an S corporation in which disqualified persons own (directly or indirectly) at least 50 percent of the S corporation shares. For this purpose, a person's interest in the S corporation in the form of synthetic equity is treated as ownership of S corporation shares and is taken into account, but only if taking it into account causes a plan year to be a nonallocation year or a person to be a disqualified person.[1244] Thus, both determinations are done with and without synthetic equity. "Disqualified persons"

[1241] Sec. 512(e). Section 511 imposes UBIT on a tax-exempt entity's income from an unrelated trade or business.

[1242] Pursuant to Sec. 409(p)(5) and (6)(C), and Treas. Reg. sec. 1.409(p)-1(f),"synthetic equity" is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future; a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value; and rights to nonqualified deferred compensation (even though it is neither payable in, nor calculated by reference to, stock in the S corporation) and rights to acquire interests in certain related entities. A person can be a disqualified person, and a nonallocation year can occur based solely on interests in the S Corporation in the form of synthetic equity, even if the person is not a participant in the ESOP. Synthetic equity is an interest in income attributable to employer stock held by an ESOP, and reduces the ESOP's economic ownership of the S corporation. On the other hand, it is possible in certain circumstances to grant options or warrants for S corporation stock (or other synthetic equity) to a single person that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the S corporation stock without causing a nonallocation year.

[1243] Generally a "prohibited allocation" for the benefit of a disqualified person occurs during a nonallocation year to the extent that S corporation employer stock owned by the ESOP (and any assets attributable to such stock) is held for the benefit of a disqualified person during the nonallocation year (whether the stock is allocated to the person's account under the ESOP during the nonallocation year or an earlier year).

[1244] An ESOP maintained by an S corporation may be able prevent a nonallocation year (or a prohibited allocation during a nonallocation year) by transferring S corporation employer stock allocated to the account of disqualified persons (or persons expected to become disqualified persons) to a separate portion of the qualified plan (or another qualified retirement plan of the S corporation) that is not designated as an ESOP and allocate it to the accounts of those persons under the separate portion (or other plan). In that case, the qualified retirement plan is subject to UBTI with respect to those transferred shares of S corporation stock.

generally are persons who have at least a 10-percent interest (or who are a member of a family group having at least a 20-percent interest) in the portion of the S corporation shares held by the ESOP, either by having shares of S corporation employer stock allocated to the person's account under the ESOP (or being treated as having a portion of unallocated shares), or by having an interest in the S corporation in the form of synthetic equity.

Nonrecognition of gain on sale of employer stock to an ESOP

In general

A taxpayer may elect to defer the recognition of long-term capital gain on the sale of qualified securities to an ESOP maintained by a C corporation if the taxpayer purchases qualified replacement property within a specified replacement period and, immediately after the sale, the ESOP owns at least 30 percent of each class of outstanding stock, or the total value of all outstanding stock of the corporation issuing the qualified securities.[1245] Qualified securities are qualifying employer securities (as defined for ESOP purposes) that (1) are issued by a domestic C corporation that, for at least one year before and immediately after the sale, has no readily tradable securities outstanding (and no member of the C corporation's controlled group has readily tradable securities outstanding), and (2) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer.

The ESOP must preclude the allocation to certain individuals of assets attributable to the qualified securities received in the sale; an excise tax may apply in the case of a prohibited allocation.[1246] In addition, an excise tax may apply if the ESOP disposes of the qualified securities within three years of the date of the sale.[1247]

Qualified replacement property consists of any security[1248] issued by a domestic operating corporation, which did not, for the corporation's taxable year preceding the taxable year in which the security was purchased by the taxpayer seeking nonrecognition treatment, have passive investment income[1249] exceeding 25 percent of the corporation's gross receipts for such preceding taxable year. In addition, securities of the domestic corporation that issued the qualified securities (and of any member of a controlled group of corporations with such

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[1245] Sec. 1042. The taxpayer's holding period with respect to the qualified securities must be at least three years at the time of the sale.

[1246] Secs. 409(n) and 4979A.

[1247] Sec. 4978.

[1248] Security is defined for this purpose as under section 165(g), *i.e.*, a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

[1249] Passive investment income is defined for this purpose as under section 1362(d)(3)(D), relating to termination of an S corporation election.

corporation) are not qualified replacement property. The qualified replacement property must be purchased within a replacement period beginning on the date three months prior to the date the qualified securities are sold and ending twelve months after the date of such sale. The basis of the taxpayer in qualified replacement property acquired during the replacement period is reduced by an amount not greater than the amount of gain realized on the sale which was not recognized pursuant to the election provided by this provision. If a taxpayer disposes of any qualified replacement property, notwithstanding any other provision of the Code, gain (if any) must be recognized to the extent of the gain that was not recognized on the sale of stock to the ESOP, subject to certain exceptions.

Diversification Requirements for Employer Stock in Defined Contribution Plans

In general

Defined contribution plans commonly hold employer securities.[1250] Participants whose accounts include employer securities generally must be given diversification rights, that is, the right to have the participant's account invested in assets other than employer securities. The diversification requirements that apply depend on the type of plan, the type of employer securities, and the type of plan contributions invested in employer securities.

Diversification requirements for ESOPs

ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.[1251] The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (*i.e.*, age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three alternative investment options and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election; or (3) the applicable amount is transferred

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[1250] Under section 407 of ERISA, retirement plans can hold only qualifying employer securities. Any stock issued by the employer or an affiliate of the employer is a qualifying employer security. Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (*i.e.*, a bond, debenture, note, certificate or other evidence of indebtedness). ERISA imposes limits on employer securities held by a money purchase pension plan.

[1251] Sec. 401(a)(28).

within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[1252]

Diversification requirements for applicable defined contribution plans

Applicable defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities.[1253] Such a plan is required to permit applicable individuals to direct that the portion of the individual's account held in employer securities be invested in other investments. An applicable individual includes (1) a plan participant, and (2) a beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

An applicable defined contribution plan is a defined contribution plan holding securities issued by the employer or a member of the employer's controlled group of corporations that are publicly traded, that is, readily tradable on an established securities market.[1254] Subject to certain exceptions, a plan holding employer securities that are not publicly traded is generally treated as holding publicly traded employer securities if the employer (or any member of the employer's controlled group of corporations) has issued a class of stock that is a publicly traded employer security. An ESOP generally is not an applicable defined contribution plan unless it holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests applicable to section 401(k) plans.[1255] An applicable defined contribution plan does not include a one-participant retirement plan, that is, a plan that covers only the business owner or owners and the spouse(s) of the owner(s).

The diversification requirements under an applicable defined contribution plan depend on the type of contributions invested in employer securities. In the case of amounts attributable to elective deferrals and employee contributions, an applicable individual must be permitted to direct that such amounts be invested in other investments. In the case of amounts attributable to nonelective employer contributions and employer matching contributions, an applicable individual who is a participant with three years of service, a beneficiary of such a participant, or a beneficiary of a deceased participant must be permitted to direct that such amounts be invested in other assets. Applicable individuals must be given a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics.

[1252] Notice 88-56, 1988-1 C.B. 540, Q&A-16.

[1253] Code sec. 401(a)(35) and ERISA sec. 204(j).

[1254] For this purpose, "controlled group of corporations" has the same meaning as under section 1563(a), except that, in applying that section, 50 percent is substituted for 80 percent.

[1255] An ESOP that is an applicable defined contribution plan and subject to the related diversification requirements is excepted from the specific ESOP diversification requirements.

Special Types of Plans for Governmental and Tax-Exempt Employers

Tax-sheltered annuities (section 403(b) plans)

Section 403(b) plans are another form of tax-favored employer-sponsored plan that provide tax benefits similar to qualified retirement plans. Section 403(b) plans may be maintained only by (1) charitable organizations tax-exempt under section 501(c)(3), and (2) educational institutions of State or local governments (*i.e.*, public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of their employees, and the plan may provide for employees to make elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals ($17,500 for 2013) and catch-up contributions ($5,500 for 2013) under a section 401(k) plan, or, if less, the employee's compensation. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, under a special catch-up rule, an increased elective deferral limit applies under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service. In this case, the limit is increased by the least of (1) $3,000, (2) $15,000, reduced by the employee's total elective deferrals in prior years, and (3) $5,000 times the employee's years of service, reduced by the employee's total elective deferrals in prior years.[1256]

Section 403(b) plans are generally subject to the minimum coverage and nondiscrimination rules that apply to qualified defined contribution plans.[1257] However, pretax contributions and designated Roth contributions made by an employee under a salary reduction agreement (*i.e.*, elective deferrals) are not subject to nondiscrimination rules similar to those applicable to elective deferrals under section 401(k) plans. Instead, all employees of the employer generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.

[1256] Because contributions to a defined contribution plan cannot exceed an employee's compensation, contributions for an employee are generally not permitted after termination of employment. However, under a special rule, a former employee may be deemed to receive compensation for up to five years after termination of employment for purposes of receiving employer nonelective contributions under a section 403(b) plan.

[1257] As in the case of a qualified retirement plan, a governmental section 403(b) plan is not subject to these nondiscrimination rules.

Governmental section 457(b) plans

Special rules with respect to deferred compensation arrangements of State and local government and tax-exempt employers.[1258] In general, amounts deferred under an eligible deferred compensation plan, *i.e.*, a section 457(b) plan, are not currently included in income. In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).[1259] However, a governmental section 457(b) plan may include a qualified Roth contribution program, allowing a participant to elect to have all or a portion of the participant's deferrals under the plan treated as designated Roth contributions.

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals ($17,500 for 2013) and catch-up contributions ($5,500 for 2013) under a section 401(k) plan or a section 403(b) plan, or, if less, the employee's compensation. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan. In addition, under a special catch-up rule, for one or more of the participant's last three years before normal retirement age, the otherwise applicable limit is increased to the lesser of (1) two times the normal annual limit ($35,000 for 2013) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year. If a participant is eligible for both the general catch-up rule and the special section 457(b) catch-up rule, the rule that provides the higher contribution limit applies.

Plan Loans and Hardship Distributions

Plan loans

Defined contribution plans, section 403(b) plans, and governmental section 457(b) plans generally are permitted, but are not required, to offer plan loans to participants. Plan loans must comply with certain conditions so that the loan is not treated as a taxable distribution to the participant.[1260] Generally, a loan that does not satisfy all of the requirements will be treated as a deemed distribution, resulting in current income taxation and, for participants younger than 59½,

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[1258] Sec. 457.

[1259] In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis. In the case of a section 457(b) plan, including a governmental section 457(b) plan, in order for compensation for a calendar month to be deferred under the plan, an agreement to defer must be entered into before the beginning of the month.

[1260] Sec. 72(p). Generally, if a participant or beneficiary assigns or pledges any portion of his or her interest in a qualified plan as security for a loan, the assigned or pledged portion is treated as a loan from the plan to the participant for purposes of section 72(p).

a 10-percent early distribution tax. The requirements both limit the amount of the loan and the repayment terms. If the actual repayment of the loan does not satisfy the required repayment terms during the period the loan is outstanding, a deemed distribution of the loan outstanding occurs at that time.

In order not to be treated as a deemed distribution, a plan loan may not exceed the lesser of (1) $50,000 reduced by the excess of the highest outstanding loan balance from the plan during the one-year period ending on the day before the date on which the loan is made over the outstanding loan balance on the date on which the loan is made, or (2) the greater of (a) 50 percent of the present value of the vested accrued benefit of the participant or (b) $10,000. Generally, a plan loan is treated as a deemed distribution unless it provides for repayment within five years of the loan date [1261] and for substantially equal payments of both principal and interest at least no less frequently than quarterly over the term of the loan.[1262]

Deemed distributions, resulting from a failure to comply with the Code's loan requirements, are treated as actual distributions for tax purposes. They are not, however, treated as actual distributions for purposes of plan qualification or rollovers requirements.

Distribution of a plan loan offset amount occurs when, pursuant to plan terms, the accrued benefit of a participant or beneficiary is reduced in order to repay a loan. For example, it is common for plans to provide that, if a participant requests a plan distribution while a loan is outstanding, the loan must be repaid immediately or treated as in default. In the event of a loan offset, the amount of the account balance that is offset against the loan is an actual, not a deemed, distribution. In contrast to a deemed distribution, a loan offset amount can be an eligible rollover distribution. A plan is not, however, required to offer a direct rollover with respect to the loan offset amount and the amount is generally not subject to mandatory 20-percent withholding.

Hardship distributions

Hardship distributions are an exception to the general prohibition on in-service distributions before age 59½ of amounts in a section 401(k) plan or 403(b) plan that are attributable to elective deferrals.[1263] Section 401(k) and 403(b) plans are permitted, but are not

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[1261] There is an exception to the five-year rule in the case of a loan used to purchase the participant's principal residence. Plans also may suspend repayment of a loan while the participant is performing services in the uniformed services of the United States. The loan repayments must resume, however, on completion of the period of military service and the loan must be repaid by amortization in substantially level installments over a period ending no later than the end of the latest permissible term (generally five years) plus the permitted period of suspension for military leave). Treas. Reg. sec. 1.72(p)-1, Q&A-9(b) and (c).

[1262] Repayment on an accelerated schedule is permitted, as is a plan requirement of full repayment on termination of employment. Substantially level amortization does not apply to periods of a year or less during which the participant is on a leave of absence without pay.

[1263] Sec. 401(k)(2)(B)(i)(IV). This exception does not apply to other contributions subject to the limitations on in-service distributions under section 401(k)(2)(B), such as safe harbor nonelective or matching contributions.

required, to permit participants to take hardship withdrawals, provided two conditions are met. First, the distribution must be made on account of an immediate and heavy financial need of the employee. Second, the distribution must be necessary to satisfy that financial need. Determinations regarding whether an immediate and heavy financial need exists, and whether a distribution is necessary to meet that need, must be made in accordance with nondiscriminatory and objective standards set forth in the plan.[1264] There are, however, regulatory safe harbors whereby the requirements may be deemed to have been met, such as for the purchase of a home or the payment of education expenses.[1265] Hardship distributions must generally be limited to the amount of the employee's total elective deferrals as of the date of the distribution, reduced by the amount of any previous hardship distributions.

Section 457(b) plans may provide for distributions in the case of an unforeseeable emergency.[1266] The concept of unforeseeable emergency is more narrow than the concept of hardship under the section 401(k) and 403(b) rules and the regulatory safe harbors do not apply.

Lifetime Income under Defined Contribution Plans

As discussed above, pension plans (defined benefit and money purchase pension plans) are required to provide participants with life annuity forms of benefit, including forms that provide life annuity benefits for surviving spouses. Pension plans are viewed as furthering retirement income security in that a participant (or surviving spouse) receiving benefits in life annuity form cannot "outlive" his or her benefits under the plan.[1267] However, profit-sharing and stock bonus plans are not required to offer annuity forms of distribution; instead, a participant's (or surviving spouse's) benefit consists of an account balance, which can be depleted during the participant's (or surviving spouse's) lifetime.[1268] The increase in the number of employees who are covered only by a profit-sharing plan or stock bonus plan (including section 401(k) plans, which are usually profit-sharing plans) has increased concern that participants (and surviving spouses) will outlive their account balances. Similar concerns arise with respect to IRA owners.[1269]

[1264] Treas. Reg. sec. 1.401(k)-1(d)(3)(i).

[1265] Treas. Reg. secs. 1.401(k)-1(d)(3) and 1.403(b)-6(d)(2).

[1266] Sec. 457(d)(1)(iii).

[1267] Social Security benefits already represent annuitization of a significant portion of retirement income for many individuals. According to the March 2010 Annual Social and Economic Supplement to the Current Population Survey, social security benefits provide at least 50 percent of total income for 66 percent of beneficiaries age 65 or older, and at least 95 percent of total income for 35 percent of beneficiaries. Social Security Administration, "Fast Facts and Figures about Social Security, 2011," SSA Publication No. 13-11785, August 2011, p. 7.

[1268] Although defined benefit plans are required to offer annuities, they may also offer lump sums, and many participants elect to receive a lump sum (perhaps rolling it over to an IRA), rather than an annuity.

[1269] Much of the savings in IRAs results from rollovers from qualified retirement plans. In addition, profit-sharing (and stock bonus) plans often offer lump sums as the only form of distribution. In that case, a participant

Lifetime income concerns have been a focus of discussion in recent years and of an initiative by the Department of the Treasury and the IRS in collaboration with the DOL to expand the availability of options that enable a participant or surviving spouse to take distributions in a form that is more likely to last over his or her lifetime ("lifetime income").[1270] These agencies have sought public input on changes that would encourage employers to include lifetime income options in defined contribution plans and to encourage defined contribution plan participants and IRA owners to elect such options, at least with respect to part of their account balances.[1271] In response to comments, changes have been proposed to the minimum required distribution rules (discussed below) to provide special rules for annuity contracts under which payments may begin at age 85.[1272] In separate guidance, the IRS clarifies the application of the spousal consent and QJSA and QPSA requirements when a deferred annuity contract is offered as an investment option under a profit-sharing plan.[1273]

3. Defined benefit plans

General Description and Rules

As described above, under a defined benefit plan, benefits are determined under a plan formula, rather than based on an actual account balance or plan assets. Traditionally, benefits under a defined benefit plan have been expressed as a life annuity commencing at normal retirement age (as designated under the plan), with accruals for each year of service expressed as a percentage of compensation (generally the participant's highest average compensation for a period of years). However, recent decades have seen the development and growth of hybrid defined benefit plans, such as cash balance plans, under which a participant's benefit is expressed as a hypothetical account balance. For example, accruals under a cash balance plan

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wishing to take installment distributions has to roll his or her account balance over to an IRA and take installments from the IRA.

[1270] An annuity by definition provides lifetime income, but lifetime income options also include, for example, installment payments over an individual's lifetime.

[1271] Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (February 2, 2010).

[1272] Because the annuity is scheduled to begin at a time when an individual's life expectancy has declined, such an annuity contract generally costs much less than a contract providing an annuity with an earlier start date. Because the individual's retirement account balances are likely to have been at least partially depleted by the time the annuity is scheduled to begin, such an annuity is sometimes referred to as a longevity annuity or longevity insurance.

[1273] Rev. Rul. 2012-3, 2012-8 I.R.B. 383. As part of the same lifetime income project, the IRS issued guidance to increase annuity distributions from defined benefit plans. Proposed changes to regulations under section 417(e), relating to the calculation of minimum lump sums, address the situation in which a participant's accrued benefit under a defined benefit plan is bifurcated and the bifurcated portions paid in separate forms, such as an annuity and a lump sum. Prop. Treas. Reg. sec. 1.417(e)-1(d), 77 Fed. Reg. 5454 (February 2, 2012). In addition, Rev. Rul. 2012-4, 2012-8 I.R.B. 386, provides guidance on transferring a participant's account balance under a defined contribution plan to a defined benefit plan in order to provide an increased annuity under the defined benefit plan.

are expressed as hypothetical contributions to the account (or "pay credits") with a right to future hypothetical earnings (or "interest credits").

Defined benefit plans are generally funded by employer contributions, in an amount determined on an actuarial basis to be needed to provide the benefits under the plan, and employers are subject to minimum funding requirements with respect to defined benefit plans (other than most governmental and church plans). Employers therefore bear the risk of investment loss on plan assets and benefit from investment gains, subject to the employer's ability to terminate the plan in the case of bankruptcy without fully funding the benefits earned under the plan. Most defined benefit plans of private employers are insured by the Pension Benefit Guaranty Corporation ("PBGC"), for which specified premiums are required.[1274]

Some defined benefit plans (including most governmental defined benefit plans) also require employee contributions. Employer contributions to a defined benefit plan are currently deductible (subject to limits), but benefits are not includible in employee's income until distributed. Employee contributions to defined benefit plans are generally made on an after-tax basis, except in the case of employee contributions to a State or local government plan that are "picked up" by the employer.[1275]

Defined benefit plans may not provide for in-service distributions before age 62 (or normal retirement age, if earlier) or in the case of plan termination. Defined benefit plans must allow participants who have terminated employment and reached normal retirement age to receive distributions and often provide for distributions on early retirement or other severance from employment before normal retirement age. Defined benefit plans, including hybrid plans, must generally provide benefits in the form of an annuity payable at normal retirement age (or any other time a distribution is made), but may also provide benefits in other forms, including lump sums.

Annuity distributions from a defined benefit plan for a year cannot exceed the lesser of $205,000 (for 2013) or the employee's average compensation for the three consecutive years of highest compensation for the employee.[1276] The dollar limit is reduced if distributions begin before age 62 and increased if distributions begin after age 65. An actuarially adjusted limit applies to a form of benefit other than an annuity, such as a lump sum.

Vesting and Related Rules

For purposes of the vesting requirements, in the case of a defined benefit plan, a participant's accrued benefit at any given time is the portion of the annuity payable at normal retirement age under the plan's benefit formula (the "normal retirement benefit") that the

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[1274] Title IV of ERISA.

[1275] Section 414(h)(2).

[1276] Section 415(b). After-tax employee contributions to a defined benefit plan are taken into account in applying the limit on contributions to a defined contribution plan as discussed below.

participant has earned as of that time. That is, if a participant terminates employment before reaching normal retirement age, the benefit to which the participant is entitled is the accrued benefit (to the extent vested). A defined benefit plan using a traditional benefit formula may use one of two vesting schedules for the portion of the accrued benefit attributable to employer contributions:[1277] (1) 100 percent vesting after completion of no more than five years of service ("five-year cliff vesting") and (2) vesting of no less than 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period from three to seven years of service. A hybrid plan must use a vesting schedule of 100 percent vesting after completion of no more than three years of service. In conjunction with the vesting requirements, "anti-backloading" rules require that participants earn (*i.e.*, accrue) benefits in a relatively even pattern over their period of service in order to prevent benefits from being denied to shorter-service employees by delaying accruals until later years of service.[1278]

A defined benefit plan is permitted to provide a wide variety of optional forms of distribution with respect to the accrued benefit, but each form must be at least the actuarial equivalent of the accrued benefit.[1279] The assumptions for determining actuarial equivalence (interest rate and mortality) must be specified in the plan in a manner that precludes employer discretion. In the case of certain forms of benefit, including lump sums, specific actuarial assumptions must be used.[1280] A defined benefit plan may provide for a subsidized early retirement benefit or other retirement type subsidies, the right to which is not required to vest or accrue in accordance with the vesting schedules or anti-backloading requirements. For example, a plan with a normal retirement age of 65 might provide for payment of a participant's accrued benefit at age 55 without actuarial reduction for early commencement, but conditioned on the participant's having at least 30 years of service.

Under the "anti-cutback" rules, amendments that reduce the employee's accrued benefit (whether or not vested), or eliminate optional forms of benefit or eliminate or reduce early retirement benefits or retirement-type subsidies with respect to the employee's accrued benefit, generally are prohibited.[1281] Amendments are generally permitted to reduce future rates of accrual, or eliminate optional forms of benefits or eliminate or reduce early retirement benefits or retirement-type subsidies, only with respect to future accruals. Exceptions to the "anti-cutback" rules apply, including in the case of underfunded defined benefit plans.

[1277] Specific rules apply for determining the portion of a participant's accrued benefit under a defined benefit plan that is attributable to employee contributions.

[1278] Sec. 411(b).

[1279] A defined benefit plan may also provide for "ancillary" benefits, which are not part of the participant's accrued benefit, such as disability or death benefits. Ancillary benefits are not subject to the vesting requirements and generally can be eliminated or reduced retroactively by a plan amendment.

[1280] Sec. 417(e). Special rules apply for valuing the accrued benefit under certain hybrid plans.

[1281] Sec. 411(d)(6).

Spousal protections applicable to defined benefit plans generally require that benefits be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant elects a different form of distribution and the participant's spouse provides notarized consent to the election. A QJSA is generally a life annuity for the participant with an annuity of at least 50 percent of the participant's annuity amount payable to the surviving spouse after the participant's death. A married participant must also be offered a qualified optional survivor annuity ("QOSA"), which is also a life annuity for the participant with an annuity payable to the surviving spouse as a percentage of the participant's annuity, with the required percentage depending on the QJSA percentage. Specifically, if the survivor annuity under the QJSA is less than 75 percent of the participant's annuity, the survivor annuity under the QOSA must be 75 percent, and, if the survivor annuity under the QJSA is 75 percent or more of the participant's annuity, the survivor annuity under the QOSA must be 50 percent. If a married participant dies before benefits begin, the plan must offer a survivor benefit for the spouse in the form of a qualified preretirement survivor annuity ("QPSA"), which is a survivor annuity for the spouse that is at least 50 percent of the employee's accrued benefit.

Funding and Deduction Rules for Defined Benefit Plans

In general

Funding requirements and waivers

Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan. The amount of required annual contributions depends on whether the plan is a single-employer plan or a multiemployer plan and is determined under certain actuarial methods.[1282] An employer is subject to a two-tier excise tax for a failure to make required contributions unless a funding waiver is obtained.[1283] The initial tax is 10 percent of the plan's aggregate unpaid minimum required contributions in the case of a single employer plan or five percent of the plan's accumulated funding deficiency in the case of a multiemployer plan. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the IRS or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the aggregate unpaid minimum required contributions or the accumulated funding deficiency, whichever is applicable.

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year (a "funding" waiver).[1284] In the case of a single-employer plan, a funding waiver may be granted if the employer responsible for the

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[1282] Secs. 412 and 430-432. Parallel requirements are contained in sections 301-305 of ERISA. PPA substantially revised the funding rules for single-employer plans, generally effective for plan years beginning after December 31, 2007. The same funding rules generally apply also to multiple-employer plans.

[1283] Sec. 4971.

[1284] Sec. 412(c).

contribution could not make the required contribution without temporary substantial business hardship. In the case of a multiemployer plan, a funding waiver may be granted if 10 percent or more of the employers responsible for the contribution could not make the required contribution without substantial business hardship. In addition, in both cases, a funding waiver may be granted only if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers (five in the case of a multiemployer plan) may be granted within any period of 15 consecutive plan years. Additional requirements apply, including notice to participants and the PBGC, restrictions on benefit increases, and security in the case of some single-employer plan funding waivers, as well as conditions that the IRS may require.

Deduction limits

The deduction limit for employer contributions to a defined benefit plan for a year depends on whether the plan is a single-employer plan or a multiemployer plan. However, the deduction limit is never less than the contribution required under the minimum funding rules applicable to the plan. Special deduction rules apply if an employer maintains both a defined contribution plan and a defined benefit plan.

Single-employer plans

Minimum required contributions

The minimum required contribution for a plan year for a single-employer defined benefit plan generally depends on a comparison of the value of the plan's assets, reduced by any prefunding balance or funding standard carryover balance ("net value of plan assets"),[1285] with the plan's funding target and target normal cost. The plan's funding target for a plan year is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is generally the present value of benefits expected to accrue or to be earned during the plan year plus the administrative expenses expected to be paid during the year. Specified interest (as discussed below) and mortality assumptions apply in determining present value for this purpose.

If the net value of plan assets is less than the plan's funding target, so that the plan has a funding shortfall (discussed further below), the minimum required contribution is the sum of the plan's target normal cost and the shortfall amortization charge for the plan year (determined as described below).[1286] If the net value of plan assets is equal to or exceeds the plan's funding

[1285] The value of plan assets is generally reduced by any prefunding balance or funding standard carryover balance in determining minimum required contributions. A prefunding balance results from contributions to a plan that exceed the minimum required contributions. A funding standard carryover balance results from a positive balance in the funding standard account that applied under the funding requirements in effect before PPA. Subject to certain conditions, a prefunding balance or funding standard carryover balance may be credited against the minimum required contribution for a year, reducing the amount that must be contributed.

[1286] If the plan has obtained a funding waiver within the past five years, the minimum required contribution also includes the related waiver amortization charge, that is, the annual installment needed to amortize the waived amount in level installments over the five years following the year of the waiver.

target, the minimum required contribution is the plan's target normal cost, reduced by the amount, if any, by which the net value of plan assets exceeds the plan's funding target.

Shortfall amortization charge

The shortfall amortization charge for a plan year is the sum of the annual shortfall amortization installments attributable to the shortfall bases for that plan year and the six previous plan years. Generally, if a plan has a funding shortfall for the plan year, a shortfall amortization base must be established for the plan year.[1287] A plan's funding shortfall is the amount by which the plan's funding target exceeds the net value of plan assets. The shortfall amortization base for a plan year is: (1) the plan's funding shortfall, minus (2) the present value of the aggregate total of the shortfall amortization installments, determined using specified interest rates as discussed below, that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases for the six previous plan years. The shortfall amortization base is amortized in level annual installments ("shortfall amortization installments") over a seven-year period beginning with the current plan year and using the specified interest rates discussed below.[1288]

The shortfall amortization base for a plan year may be positive or negative, depending on whether the present value of remaining installments with respect to amortization bases for previous years is more or less than the plan's funding shortfall. If the shortfall amortization base is positive (that is, the funding shortfall exceeds the present value of the remaining installments), the related shortfall amortization installments are positive. If the shortfall amortization base is negative, the related shortfall amortization installments are negative. The positive and negative shortfall amortization installments for a particular plan year are netted when adding them up in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero (*i.e.*, negative amortization installments may not offset normal cost).

If the net value of plan assets for a plan year is at least equal to the plan's funding target for the year, so the plan has no funding shortfall, any shortfall amortization bases and related shortfall amortization installments are eliminated.[1289] As indicated above, if the net value of plan

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[1287] If the value of plan assets, reduced only by any prefunding balance if the employer elects to apply the prefunding balance against the required contribution for the plan year, is at least equal to the plan's funding target, no shortfall amortization base is established for the year.

[1288] Under the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 ("PRA 2010"), Pub. L. No. 111-192, employers were permitted to elect to use one of two alternative extended amortization schedules for up to two "eligible" plan years during the period 2008-2011. The use of an extended amortization schedule has the effect of reducing the amount of the shortfall amortization installments attributable to the shortfall amortization base for the eligible plan year. However, the shortfall amortization installments attributable to an eligible plan year may be increased by an additional amount, an "installment acceleration amount," in the case of employee compensation exceeding $1 million, extraordinary dividends, or stock redemptions within a certain period of the eligible plan year.

[1289] Any amortization base relating to a funding waiver for a previous year is also eliminated.

assets exceeds the plan's funding target, the excess is applied against target normal cost in determining the minimum required contribution.

Interest rate used to determine target normal cost and funding target

The minimum funding rules for single-employer plans specify the interest rates and other actuarial assumptions that must be used in determining the present value of benefits for purposes of a plan's target normal cost and funding target.

Present value is generally determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. Each segment rate is a single interest rate determined monthly by Treasury Department on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. The IRS publishes the segment rates each month.

For plan years beginning after December 31, 2011, a segment rates is adjusted if the rate determined under the regular rules is outside a specified range of the average of the segment rates for the preceding 25-year period ("average" segment rates).[1290] In particular, if a segment rate determined for an applicable month under the regular rules is less than the applicable minimum percentage, the segment rate is adjusted upward to match that percentage. If a segment rate determined for an applicable month under the regular rules is more than the applicable maximum percentage, the segment rate is adjusted downward to match that percentage. For this purpose, the average segment rate is the average of the segment rates determined under the regular rules for the 25-year period ending September 30 of the calendar year preceding the calendar year in which the plan year begins. The IRS publishes the average segment rates each month.

[1290] Sec. 40211 of the Moving Ahead for Progress in the 21st Century Act (''MAP-21''), Pub. L. No. 112-141. Besides being used in determining minimum required contributions, the segment rates are used for other purposes, such as determining minimum lump sum benefits under section 417(e). MAP-21 limits the purposes for which segment rates as adjusted under MAP-21 are used.

The applicable minimum percentage and the applicable maximum percentage depend on the calendar year in which the plan year begins as shown by the following table:

If the calendar year is:	The applicable minimum percentage is:	The applicable maximum percentage is:
2012	90 percent	110 percent
2013	85 percent	115 percent
2014	80 percent	120 percent
2015	75 percent	125 percent
2016 or later	70 percent	130 percent

Thus, for example, if the first segment rate determined for an applicable month under the regular rules for a plan year beginning in 2013 is less than 85 percent of the average of the first segment rates determined under the regular rules for the 25-year period ending September 30, 2012, the segment rate is adjusted to 85 percent of the 25-year average.

Solely for purposes of determining minimum required contributions, in lieu of the segment rates (or adjusted segment rates) described above, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (*i.e.*, without regard to the 24-month averaging described above) ("monthly yield curve"). If an election to use a monthly yield curve is made, it cannot be revoked without IRS approval.

At-risk assumptions

Special assumptions generally apply in determining the funding target and normal cost of a plan in at-risk status ("at-risk" assumptions). Whether a plan is in at-risk status for a plan year depends on its funding target attainment percentage for the preceding year. A plan's funding target attainment percentage for a plan year is the ratio, expressed as a percentage, that the net value of the plan's assets bears to the plan's funding target for the year. A plan is in at-risk status for a year if, for the preceding year: (1) the plan's funding target attainment percentage, determined without regard to the at-risk assumptions, was less than 80 percent, and (2) the plan's funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70 percent.[1291]

[1291] A similar test applies in order for an employer to be permitted to apply a prefunding balance against its required contribution, that is, for the preceding year, the ratio of the value of plan assets (reduced by any prefunding balance) must be at least 80 percent of the plan's funding target (determined without regard to the at-risk rules).

If a plan is in at-risk status, the plan's funding target and normal cost are determined using the assumptions that: (1) all employees who are not otherwise assumed to retire as of the valuation date, but who will be eligible to elect benefits in the current and 10 succeeding years, are assumed to retire at the earliest retirement date under plan, but not before the end of the plan year; and (2) all employees are assumed to elect the retirement benefit available under the plan at the assumed retirement age that results in the highest present value. In some cases, a loading factor also applies of four percent of the plan's funding target or normal cost, as applicable, determined without regard to at-risk status, plus, in the case of the plan's funding target, $700 times the number of participants. The effect of the at-risk assumptions on funding target and target normal cost is phased in over five years beginning with the first year of at-risk status.

Value of plan assets

In applying the single-employer funding rules, the value of plan assets generally is the fair market value of the assets. However, the value of plan assets may be determined on the basis of the averaging of fair market values, but only if such method: (1) is permitted under regulations; (2) does not provide for averaging of fair market values over more than the period beginning on the last day of the 25th month preceding the month in which the plan's valuation date occurs and ending on the valuation date; and (3) does not result in a determination of the value of plan assets that at any time is less than 90 percent or more than 110 percent of the fair market value of the assets at that time. Any averaging must be adjusted for plan contributions, distributions, and expected earnings on plan assets (as determined actuarially on the basis of an assumed rate of return not exceeding the third segment rate), as specified in administrative guidance.

Timing of plan contributions

Minimum required contributions for a plan year must generally be made no later than 8½ months after the end of the plan year. Quarterly contributions must be made during a plan year if the plan had a funding shortfall for the preceding plan year.

Funding-related benefit restrictions

Restrictions on benefit increases, certain types of benefits and benefit accruals (collectively referred to as "benefit restrictions") may apply to a plan if the plan's adjusted funding target attainment percentage is below a certain level.[1292] Adjusted funding target attainment percentage is determined in the same way as funding target attainment percentage, except that the net value of plan assets and the plan's funding target are both increased by the aggregate amount of purchases of annuities for employees, other than highly compensated employees, made by the plan during the two preceding plan years. Reductions required to comply with the benefit restrictions are not precluded by the anti-cutback rules.

[1292] Sec. 436.

Deduction limit

The deduction limit for contributions to a single-employer plan is generally the excess of (1) the sum of the plan's funding target (the present value of benefits earned under the plan in previous years), normal cost (the present value of the benefits expected to be earned during the year plus plan expenses) and a "cushion" amount, over (2) the value of plan assets. The cushion amount is the sum of 50 percent of the plan's funding target and the amount by which the funding target would increase if certain expected future compensation or benefit increases were taken into account.

Multiemployer plans

Minimum required contributions

In connection with the funding requirements, a multiemployer defined benefit plan maintains a notional account called a "funding standard account" to which specific charges and credits (including plan contributions) are made for each plan year the multiemployer plan is maintained. The minimum required contribution for a plan year is the amount, if any, needed so that the accumulated credits to the funding standard account as of that plan year are not less than the accumulated charges (*i.e.*, so the funding standard account does not have a negative balance). If, as of the close of a plan year, accumulated charges to the funding standard account exceed credits, the plan has an "accumulated funding deficiency" equal to the amount of the excess. For example, if, as of a plan year, the balance of charges to the funding standard account would be $200,000 without any contributions, then a minimum contribution equal to that amount is required to meet the minimum funding standard for the year (*i.e.*, to prevent an accumulated funding deficiency). If credits to the funding standard account exceeds charges, a "credit balance" results. The amount of the credit balance, increased with interest, reduces future required contributions.

Funding method; charges and credits to the funding standard account

A multiemployer plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges to the funding standard account consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions (*e.g.*, interest and mortality) had been fulfilled. A plan's normal cost for a plan year is charged to the funding standard account for that year.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common

supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses (*e.g.*, worse than expected investment returns or actuarial experience), losses from changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs are amortized (*i.e.*, recognized for funding purposes) over a specified number of years (generally 15 years) by annual charges to the funding standard account over that period.[1293]

Factors that result in a supplemental loss can alternatively result in a gain that is recognized by annual credits to the funding standard account over a 15-year amortization period (in addition to a credit for contributions made each the plan year). These include a reduction in plan liabilities as a result of a plan amendment decreasing plan benefits, net experience gains (*e.g.*, better than expected investment returns or actuarial experience), and gains from changes in actuarial assumptions.

Actuarial assumptions; value of plan assets

In applying the funding rules to a multiemployer plan, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations). In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan. The interest rate used in funding computations, which represents the expected return on plan assets over time, is subject to these general standards; the funding rules do not specify the interest rate that must be used.

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined under a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used generally must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period generally not to exceed the five most recent plan years, including the current year.[1294]

[1293] PPA made some changes to the funding rules for multiemployer plans, including changes to the amortization periods for some funding standard account charges and credits, effective for amounts first amortized in plan years beginning after 2007. PPA also changed the rules under which the IRS may grant an extension of the amortization period used in determining certain charges to the funding standard account, so that in some circumstances a five-year extension is automatic with an additional five-year extension available if certain requirements are met. These PPA changes sunset (*i.e.*, no longer apply) for plan years beginning after December 31, 2014.

[1294] PRA 2010 allowed multiemployer plans meeting certain requirements to use longer periods to recognize losses from the 2008 market downturn, both in determining charges to the funding standard account and the actuarial value of plan assets.

Additional requirements for plans in reorganization status or insolvent plans

Certain modifications to the funding rules apply to multiemployer plans that experience financial difficulties, referred to as "reorganization status."[1295] A plan is in reorganization status for a year if the contribution needed to balance the charges and credits to its funding standard account exceeds its "vested benefits charge." The plan's vested benefits charge is generally the amount needed to amortize, in equal annual installments, unfunded vested benefits under the plan over: (1) 10 years in the case of obligations attributable to participants in pay status; and (2) 25 years in the case of obligations attributable to other participants. A plan in reorganization status is eligible for a special funding credit. In addition, a cap on year-to-year contribution increases and other relief is available to employers that continue to contribute to the plan.

Subject to certain requirements (including notice to participants, any employee organization representing participants, and contributing employers), a multiemployer plan in reorganization status may also be amended to reduce or eliminate accrued benefits in excess of the amount of benefits guaranteed by the PBGC. Benefits may be reduced or eliminated notwithstanding the anti-cutback rules, which generally require that accrued benefits may not be decreased by plan amendment. Active and inactive participants must generally be treated similarly with respect to benefit reductions made under a plan in reorganization status.

Benefit reductions may also apply if a multiemployer plan is insolvent.[1296] A plan is insolvent when its available resources in a plan year are not sufficient to pay the plan benefits for that plan year, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year. Notwithstanding the anti-cutback rules, an insolvent plan is required to reduce benefits to the level that can be covered by the plan's assets. However, benefits cannot be reduced below the level guaranteed by the PBGC. If a multiemployer plan is insolvent, the PBGC guarantee is provided in the form of loans to the plan trustees. If the plan recovers from insolvency status, loans from the PBGC can be repaid. Plans in reorganization status are required to compare assets and liabilities to determine if the plan will become insolvent in the future.

Additional requirements for plans in endangered or critical status

Additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status, effective for plan years beginning after December 31, 2007, and before January 1, 2015.[1297] These rules require the adoption of and compliance with: (1) a funding improvement plan in the case of a multiemployer plan in endangered status; and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are

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[1295] Secs. 418-418D. Parallel rules are contained in sections 4241-4244A of ERISA.

[1296] Sec. 418E. Parallel rules are contained in section 4245 of ERISA.

[1297] Sec. 432, enacted by PPA.

relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Deduction limit

The deduction limit for employer contributions to a multiemployer plan is generally the excess of (1) 140 percent of the plan's current liability (the present value of all benefits earned under the plan), over (2) the value of plan assets. This limit applies to the total contributions made by all employers participating in the multiemployer plan.

PBGC Insurance Program

Single-employer defined benefit plans

In the case of a single-employer defined benefit plan, flat-rate premiums apply at a rate of $42 per participant for 2013 and $49 per participant for 2014 with indexing thereafter.

If a single-employer defined benefit plan has unfunded vested benefits, variable-rate premiums also apply at a rate of $9 per $1,000 of unfunded vested benefits divided by the number of participants. Beginning 2013, the rate for variable-rate premiums is indexed and the per-participant variable-rate premium is subject to a limit. The limit is $400 for 2013 with indexing thereafter. In addition, the rate for variable-rate premiums ($9 per $1,000 of unfunded vested benefits) is increased (after indexing) by $4 for 2014 and $5 for 2015 and indexing continues to apply thereafter. For purposes of determining variable-rate premiums, unfunded vested benefits are equal to the excess (if any) of (1) the plan's funding target for the year determined as under the minimum funding rules, but taking into account only vested benefits, over (2) the fair market value of plan assets. In determining the plan's funding target for this purpose, the interest rates used are segment rates determined as under the minimum funding rules, but determined on a monthly basis, rather than using a 24-month average of corporate bond rates and without adjustments for 25-year average rates.

In the case of a single-employer plan, the PBGC guarantee limit is the indexed dollar amount applicable for the year of plan termination and applies to annuity benefits commencing at age 65, with a reduced or increased limit for earlier or later commencement. For plans terminating in 2013, the guarantee limit is $57,477 for benefits commencing at age 65.

Multiemployer defined benefit plans

In the case of a multiemployer plan, flat-rate premiums apply at a rate of $12 per participant for 2013 with indexing thereafter.

In the case of a multiemployer plan, the PBGC guarantee limit is the sum of 100 percent of the first $11 of monthly benefits plus 75 percent of the next $33 of monthly benefits for each year of service.

Reversions of Defined Benefit Plan Assets and Transfers for Retiree Health and Group-Term Life Insurance Benefits

Reversions

Defined benefit plan assets generally may not revert to an employer before termination of the plan and the satisfaction of all plan liabilities.[1298] In addition, the plan must provide for the reversion. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan.

Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax.[1299] The excise tax rate is generally 20 percent, but increases to 50 percent if the employer does not maintain a replacement plan or make certain benefit increases.

Use of excess plan assets for retiree health and group term life insurance benefits

Subject to various conditions, a qualified transfer of excess assets of a defined benefit plan may be made to a retiree medical account or life insurance account within the plan in order to fund retiree health benefits and group term life insurance benefits ("applicable retiree benefits").[1300] For this purpose, excess assets generally means the excess, if any, of the value of the plan's assets over 125 percent of the sum of the plan's funding target and target normal cost for the plan year. A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. No deduction is allowed to the employer for (1) a qualified transfer, or (2) the payment of applicable retiree benefits out of transferred funds (and any income thereon).

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation). In addition, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[1301]

[1298] The accrued benefits of all plan participants are required to be fully vested on plan termination.

[1299] Sec. 4980.

[1300] Sec. 420. Before MAP-21, a qualified transfer was permitted only to fund retiree health benefits. Section 40242 of MAP-21 extended qualified transfers to retiree group-term life insurance coverage, effective for transfers after July 6, 2012 (the date of enactment of MAP-21).

[1301] ERISA sec. 101(e).

No more than one qualified transfer may be made in any taxable year. For this purpose, a transfer to a retiree medical account and a transfer to a retiree life insurance account in the same year are treated as one transfer. No qualified transfer may be made after December 31, 2021.

4. Individual retirement arrangements

Traditional and Roth Individual Retirement Arrangements

Contribution limits

In general

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[1302] to which both deductible and nondeductible contributions may be made,[1303] and Roth IRAs, to which only nondeductible contributions may be made.[1304] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) but, if certain requirements are satisfied, distributions are not includible in gross income.

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 2013) 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.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. Thus, for example, if an individual over age 50 contributes $6,500 to a Roth IRA for 2013 ($5,500 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for that year. In addition, deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in

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[1302] Sec. 408.

[1303] Sec. 219.

[1304] Sec. 408A.

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 AGI for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2013 are: (1) for single taxpayers, $59,000 to $69,000; (2) for married taxpayers filing joint returns, $95,000 to $115,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2013 between $178,000 and $188,000.

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 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 prior to the close of a year is not permitted to make contributions to a traditional IRA.

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. The AGI phase-out ranges for 2013 are: (1) for single taxpayers, $112,000 to $127,000; (2) for married taxpayers filing joint returns, $178,000 to $188,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

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 a traditional IRA into a Roth IRA.[1305] The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that

[1305] For taxable years beginning prior to January 1, 2010, taxpayers with modified AGI in excess of $100,000 and married taxpayers filing separate returns were generally not permitted to convert a traditional IRA into a Roth IRA. Under the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, these limits on conversion are repealed for taxable years beginning after December 31, 2009. Thus, although an individual with AGI exceeding the limits described above cannot 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.

the early distribution tax (discussed below) does not apply.[1306] However, the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

A major source of the assets in IRAs is rollovers from employer-sponsored plans that are eligible retirement plans. For tax-free rollovers, distributions from nonRoth accounts under an employer-sponsored plan must be contributed to a traditional IRA and distributions from a designated Roth account are only permitted to be contributed to a Roth IRA. 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 an eligible employer plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.[1307] In the case of a distribution and rollover of property, the amount of the distribution for purposes of determining the amount includible in gross income is generally the fair market value of the property on the date of the distribution.[1308] As in the case of a Roth IRA conversion of an amount from a traditional 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.[1309]

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.[1310] In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.[1311]

Excise tax on excess contributions

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.[1312] This excise tax generally

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[1306] A special rule is provided in the case of a conversion made in 2010. In such case, unless the taxpayer elects otherwise, the amount includible in income as a result of the conversion is included in income ratably in 2011 and 2012.

[1307] Sec. 408A(d)(3) and Notice 2008-30, 2008-12 I.R.B. 638.

[1308] Treas. Reg. sec. 1.402(a)-1(a)(iii).

[1309] Sec. 408A(d)(3)(F), Treas. Reg. sec. 1.408A-6 A-5, and Notice 2008-30, Q&A-3.

[1310] Sec. 408A(d)(6).

[1311] Treas. Reg. sec. 1.408A-6.

[1312] Secs. 4973(b) and (f).

applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.[1313] To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

Taxation of Distributions from IRAs

Traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis.[1314] All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

Roth IRAs

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. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled over from other Roth IRAs); (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

Rollovers

Distributions from traditional IRAs are permitted to be rolled over tax-free to another traditional IRA or any other eligible retirement plan. A distribution from a traditional IRA may

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[1313] Sec. 408(d)(4).

[1314] Basis results from after-tax contributions to the IRA or a rollover to the IRA of after-tax amounts from another eligible retirement plan.

be rolled over to a Roth IRA, but the distribution is included in gross income as a conversion in accordance with the general rules for distributions from traditional IRAs as discussed above. The general 60-day rollover rule (discussed above) applies to IRA rollovers as well as rollovers from qualified retirement plans, section 403(b) annuities, and governmental section 457(b) plans. There is no provision for direct rollovers from an IRA, but direct payment to another eligible retirement plan generally satisfies the requirements. Distributions from an inherited IRA (except in the case of an IRA acquired by the surviving spouse by reason of the IRA owner's death) and required minimum distributions are not permitted to be rolled over.[1315] The portion of any distribution from a traditional IRA that is not includible in gross income is only permitted to be rolled over to another IRA. Distributions from a Roth IRA may only be rolled over tax-free to another Roth IRA.

Employer Retirement Plans Using IRAs

SIMPLE IRA plan

A small employer that employs no more than 100 employees who earned $5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called the SIMPLE retirement plan. A SIMPLE IRA plan is generally a plan under which contributions are made to an individual retirement arrangement for each employee (a "SIMPLE IRA"). A SIMPLE IRA plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of $12,000 (for 2013). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE IRA plan up to a limit of $2,500 (for 2013).

In the case of a SIMPLE IRA plan, the group of eligible employees generally must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year.[1316] A SIMPLE IRA plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation); however, a lower percentage cannot be elected for more than two years out of any five year period. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible

[1315] A trustee to trustee transfer between IRAs is not treated as a distribution and rollover. Thus, nonspouse beneficiaries of IRAs can move funds to another inherited IRA established as a beneficiary of the decedent IRA owner. In contrast, a surviving spouse is permitted to roll over a distribution to his or her own IRA.

[1316] An employer is permitted to exclude collectively bargained employees described in section 410(b)(3)(A).

employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution. All contributions must be fully vested.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE IRA plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.[1317]

No contributions other than employee elective contributions, required employer matching contributions, or employer nonelective contributions can be made to a SIMPLE IRA plan. Further, the employer generally may not maintain any other qualified retirement plan that provides for allocations or accruals for the year that benefit employees eligible under the SIMPLE IRA plan.

Simplified employee pensions

A simplified employee pension ("SEP") is an IRA to which the employer may make contributions for an employee up to the lesser of 25 percent of the employee's compensation or the dollar limit applicable to contributions to a qualified defined contribution plan ($51,000 for 2013).[1318] All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $550 (for 2013) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the enactment of the SIMPLE IRA plan rules. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($17,500 for 2013). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $5,500 (for 2013).

Deemed IRAs

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan.[1319] This option is available to qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the

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[1317] Notice 98-4, 1998-1 C.B. 269.

[1318] Sec. 408(k).

[1319] Sec. 408(q).

terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA. Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.[1320]

Payroll deduction IRA

An employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997,[1321] Congress indicated that "employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs." Congress encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs."[1322] In response to that directive, the IRS published guidance to remind employers of the availability of this option for their employees.[1323]

In 1975, DOL issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to ERISA.[1324] In 1999, DOL restated and updated its positions on these programs.[1325] Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.

[1320] Treas. Reg. sec. 1.408(q)-1. Special rules apply in the case of deemed IRAs under plans of State and local government employers.

[1321] Pub. L. No. 105-34.

[1322] H. Rep. No. 102-220, p. 775 (1997).

[1323] Announcement 99-2, 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

[1324] Labor Reg. sec. 2510.3-2(d).

[1325] Interpretive Bulletin 99-1, 64 Fed. Reg. 32999 (June 18, 1999); Labor Reg. sec. 2509.99-1.

5. Early distributions and required minimum distributions

Early Distributions

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and Individual Retirement Arrangements ("IRAs") before employee or an IRA owner attains age 59½.[1326] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution. This additional tax is designed to help insure that distributions from qualified retirement plans are preserved for retirement.

There are a number of exceptions to the early distribution tax. Some exceptions apply to all plans and others apply only to IRAs or only to qualified retirement plans and section 403(b) plans. The exceptions that apply to all plans include distributions due to death or disability; distributions made in the form of certain periodic payments; distributions made on account of a tax levy on the plan; distributions to the extent that they do not exceed the amount allowable as a deduction for amounts paid during the taxable year due to medical care (determined without regard to whether the employee itemizes deductions for such year);[1327] or distributions made to a member of a reserve unit called to active duty for 180 days or longer.

The exceptions that only apply to distributions from IRAs include distributions used to purchase health insurance for certain unemployed individuals; used for higher education expenses; and used for first-time homebuyer expenses of up to $10,000. The exceptions that only apply to distributions from qualified retirement plans and 403(b) plans include distributions made subsequent to the employee's separation from service after attaining age 55;[1328] distributions made to an alternate payee pursuant to a qualified domestic relations order; and distribution of dividends paid with respect to stock held by an ESOP.

Minimum Distribution Requirements

In general

Minimum distribution rules apply to tax-favored employer-sponsored retirement plans and IRAs, and limit the tax deferral allowed for these plans and arrangements. By requiring that minimum annual distributions start at a required beginning date (generally at age 70½), the rules are designed to ensure that these plans are used to provide funds for retirement. Distributions to an employee are required to begin not later than the required beginning date and to be distributed, in accordance with regulations, over the life of the employee or over the lives of the

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[1326] Sec. 72(t). The early distribution tax does not apply to distributions from governmental section 457(b) plans.

[1327] Sec. 213.

[1328] Age 50 is substituted for age 55 in the case of distributions to a qualified public safety officer from a governmental defined benefit plan.

employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee or the life expectancy of the employee and a designated beneficiary).[1329] Minimum distribution rules also apply to benefits payable with respect to an employee or IRA owner who has died.

The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA. In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the annuity stream of payments must satisfy. Failure to comply with the minimum distribution requirement may result in an excise tax imposed on the individual who was required to be the distributee equal to 50 percent of the required minimum distribution not distributed for the year.[1330] The excise tax may be waived in certain cases.

Lifetime rules

General rules

While an employee or IRA owner is alive, distributions of the individual's interest starting from the required beginning date are required to be made (in accordance with regulations) over the life or life expectancy of the employee or IRA owner, or over the joint lives or joint life expectancy of the employee or IRA owner and a designated beneficiary.[1331] For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee or IRA owner is alive, is the factor from the uniform lifetime table included in the Treasury regulations.[1332] This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 70½. For tax-favored employer-sponsored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under a tax-favored employer-sponsored retirement plan in the year the employee attains

[1329] Sec. 401(a)(9)(A).

[1330] Sec. 4974.

[1331] Sec. 401(a)(9)(A).

[1332] Treas. Reg. sec. 1.401(a)(9)-5 and -9.

age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

Proposed lifetime income rule for annuities commencing at age 85

In 2012, the IRS proposed changes to the minimum required distribution regulations to allow the value of a longevity annuity contract held in a defined contribution plan account or traditional IRA to be disregarded in some circumstances in determining minimum required distributions for years before annuity payments under the contract are scheduled to begin.[1333] Among the conditions on such disregard, the proposed regulations limit the portion of an account that can be invested in a longevity annuity contract (the lesser of 25 percent or $100,000), require the annuity to begin no later than age 85, and include disclosure and reporting requirements for the annuity issuer.

Distributions after death

Payments over a distribution period

The after-death rules vary depending on (1) whether an employee or IRA owner dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit. A designated beneficiary is an individual designated as a beneficiary under the plan.[1334] Similar to the lifetime rules, for defined contribution plans and IRAs, the required minimum distribution for each year after the death of the employee or IRA owner is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

If an employee or IRA owner dies on or after the required beginning date, the statutory rule is that the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death.[1335] For individual accounts, if there is no designated beneficiary, the distribution period is equal to the remaining years of the employee or IRA owner's life, as of the year of death. If there is a designated beneficiary, the distribution period is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of the death (if this provides a longer distribution period). [1336]

[1333] Prop. Treas. Reg. sec. 1.401(a)(9)-5, A-3, 77 Fed. Reg. 5443 (February 3, 2012). The proposed regulations, and the conditions on longevity annuity contracts, do not apply to Roth IRAs because an individual is not required to take distributions from a Roth IRA at age 70½.

[1334] Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan. There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, if an individual is named as beneficiary through the employee or IRA owner's will or the estate is named as beneficiary, there is no designated beneficiary for purposes of the minimum distribution requirements.

[1335] Sec. 401(a)(9)(B)(i).

[1336] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

If an employee or IRA owner dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, distributions are permitted to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary.[1337] For individual accounts, the distribution period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual dies on or after the required beginning date.[1338]

In all cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee or IRA owner or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period. If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

Five-year rule

If an employee or IRA owner dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee or IRA owner must generally be distributed by the end of the fifth year following the individual's death.[1339]

Defined benefit plans and annuity distributions

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.[1340] If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger

[1337] Sec. 401(a)(9)(B)(iii). Special rules apply if the beneficiary of the employee or IRA owner is the individual's surviving spouse. In that case, distributions are not required to commence until the year in which the employee or IRA owner would have attained age 70½. If the surviving spouse dies before the employee or IRA owner would have attained age 70½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee or IRA owner.

[1338] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[1339] Treas. Reg. sec. 1.401(a)(9)-3, A-2.

[1340] Treas. Reg. sec. 1.401(a)(9)-6, A-14.

than the employee or IRA owner, the survivor annuitant is limited to a percentage of the life annuity benefit for the employee or IRA owner.[1341] The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

6. Tax treatment of life insurance and annuity contracts

Life insurance contracts

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[1342] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (referred to as "inside buildup").[1343]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (*i.e.*, basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.

Annuity contracts

In general, earnings and gains on a deferred annuity contract held by an individual are not subject to tax during the deferral period in the hands of the holder of the contract (referred to as "inside buildup").[1344] When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received as an annuity (generally, as periodic payments under contract terms) or not.[1345]

For amounts received as an annuity by an individual, an exclusion ratio is provided for determining the taxable portion of each payment.[1346] The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's

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[1341] Treas. Reg. sec. 1.401(a)(9)-6, A-2.

[1342] Sec. 101(a).

[1343] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[1344] If an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract. Sec. 72(u).

[1345] Sec. 72.

[1346] Sec. 72(b).

investment in the contract[1347] to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date.[1348] Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date, and are included in income to the extent allocable to income on the contract if received before the annuity starting date (*i.e.*, as income first).[1349] In general, loans under the annuity contract, partial withdrawals and partial surrenders are treated as amounts not received as an annuity and are subject to tax as income first. Exceptions are provided in some circumstances, such as for certain grandfathered contracts, certain life insurance and endowment contracts (other than modified endowment contracts), and contracts under qualified plans. Under these exceptions, the amount received is included in income, but only to the extent it exceeds the investment in the contract, *i.e.*, as basis recovery first.

Tax-free exchanges of insurance contracts

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss.[1350] No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract or qualified long-term care contract; or (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract or for a qualified long-term care contract; or (3) an annuity contract for an annuity contract or for a qualified long-term care contract; or (4) a qualified long-term care contract for a

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[1347] Section 72 uses the term "investment in the contract" in lieu of the more generally applicable term "basis."

[1348] If an amount is received as an annuity for a period of 10 years or more, or for the lives of one or more individuals, under a portion of an annuity contract, that portion of the contract is treated as a separate contract, to which a pro rata portion of the taxpayer's investment in the contract is allocated and to which the rules for amounts received as an annuity are applied separately from the remainder of the contract.

[1349] Sec. 72(e). By contrast to distributions under an annuity contract, distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (*i.e.*, income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, *i.e.*, generally is funded more rapidly than seven annual level premiums. Sec. 7702A.

[1350] Sec. 1035.

qualified long-term care contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged.[1351]

[1351] Sec. 1031(d).

J. Present Law: Real Estate

1. Tax incentives for homeownership

Several provisions of the Code provide favorable tax treatment to homeowners. Among the most widely utilized provisions are the deductions for home mortgage interest and real property taxes paid, affecting nearly 40 million taxpayers. Taxpayers are also allowed to exclude up to $500,000 of gains from the sale of their principal residences from gross income, an exclusion not available for income from most other types of investments. Tax-exempt bond issuance may also reduce the cost of mortgage financing for certain borrowers. Several other provisions also afford favorable treatment to homeownership. A description of these provisions follows.

Home Mortgage Interest Deduction

In lieu of taking the standard deduction, a taxpayer may elect to claim an itemized deduction for qualified residence interest, subject to limitations, notwithstanding the general rule that personal interest is nondeductible.[1352] Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness

Acquisition indebtedness is indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer.

Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. 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). Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing.

The indebtedness must be secured by the qualified residence and is limited to $1 million ($500,000 for married persons filing a separate return). A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.[1353] A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

[1352] Sec. 163(h)(2)(D) and (h)(3).

[1353] Section 163(h)(4) defines qualified residence to include both a principal residence within the meaning of section 121 (relating to an exclusion of capital gain upon sale of a personal residence) and a second residence that satisfies the terms of section 280A(d)(1) (relating to whether a dwelling unit is used as a residence for purposes of the disallowance of certain deductions).

Home equity indebtedness

Certain home equity indebtedness may give rise to deductible qualified residence interest. Home equity indebtedness, for this purpose, means debt secured by the taxpayer's principal or second residence to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).

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).

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).

The deduction for interest on home equity indebtedness is not allowed in computing alternative minimum taxable income.

Points

Points (prepaid interest) paid with respect to a home mortgage (including point on a refinancing of a qualified residence of the taxpayer) are generally capitalized and amortized over the period of the indebtedness.[1354] An exception to this general rule, however, permits a current deduction for points on debt incurred for the initial purchase or improvement of the taxpayer's principal residence. This exception does not apply to the taxpayer's second residence. The deduction is allowable only to the extent the points would be deductible as qualified residence interest (if they were not prepaid).

Private mortgage insurance

Under a temporary provision, certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and

[1354] Sec. 461(g).

thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married individual filing a separate return). Reporting rules apply under the provision.

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision (December 20, 2006)).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2013, or properly allocable to any period after that date.

Deduction for Real Property Taxes

In lieu of taking the standard deduction, a taxpayer may elect to claim an itemized deduction for State, local, and foreign, real property taxes.[1355] A taxpayer may deduct the tax if it is based on the assessed value of the real property and the taxing authority charges a uniform rate on all property in its jurisdiction. The tax must be for the welfare of the general public and not be a payment for a special privilege granted or service rendered to the taxpayer.[1356]

Deductible real property taxes do not include itemized charges for services to specific property or people even if paid to the taxing authority. Charges for services include itemized charges such as a fixed charge per gallon of water used, a periodic charge for residential trash collection service, or a flat fee for a single service provided by the taxing jurisdiction (such as for mowing your lawn because its height exceeded that permitted by local ordinance).

Assessments for local benefits that tend to increase the value of the property are not deductible.[1357] These include assessments for the construction of new streets and sidewalks, or impact fees to connect to a water or sewer system. Assessments for repair or maintenance or financing costs of existing local benefits are deductible. If only part of the assessment is for

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[1355] Sec. 164(a)(1).

[1356] Treas. Reg. sec. 1.164-3(b).

[1357] Sec. 164(c)(1).

repair, maintenance, or financing costs, the taxpayer must be able to show the amount of that part to claim any deduction for that assessment.

Transfer taxes on the sale of a personal residence are not deductible real property taxes. Transfer taxes paid by the buyer are included in the cost basis of the property. Transfer taxes paid by the seller reduce the amount realized on the sale.

Homeowners association assessments are not deductible as real property taxes paid because the homeowners association imposes them rather than a State, local, or foreign government.

The deduction for real property taxes is not allowed in computing alternative minimum taxable income.

Exclusion of Gain from Sale of a Principal Residence

An individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[1358] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the years of the five year period ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains an election relating to members of the uniformed services, the Foreign Service, certain employees of the intelligence community, and employees or volunteers of the Peace Corps. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty.

Gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (1) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and (2) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use

[1358] Sec. 121.

during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

Tax Exempt Bonds for Owner-Occupied Housing

In general

Under present law, gross income generally does not include interest paid on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or that are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for State and local bonds only applies to private activity bonds if the bonds are issued for certain permitted purposes ("qualified private activity bonds"). Subject to certain requirements, qualified private activity bonds, including qualified mortgage bonds and qualified veterans' mortgage bonds ("mortgage revenue bonds"), may be issued to finance owner-occupied housing.[1359]

Qualified mortgage bonds

Owner-occupied housing may be financed with the proceeds of qualified mortgage bonds. Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied housing for single-family principal residences (and certain two to four family residences). The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the homes financed with bond proceeds, a first-time homebuyer requirement, and a new mortgage requirement. The income limitations are satisfied if all the financing provided by an issue is provided for mortgagors whose family incomes do not exceed 115 percent (increased up to 140 percent for high housing cost areas) of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The income limitations are modified for mortgagors having a family of fewer than three individuals. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence.

In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement). Under a special rule, qualified veterans' mortgage bonds (discussed in more detail below) may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement.

[1359] Sec. 143.

Qualified mortgage bonds may be used only to finance original "new" mortgages (as contrasted with refinancing of existing mortgages). Limited exceptions allow refinancing of construction loans, bridge loans, and similar temporary initial financing.

The income and purchase price limitations are modified for residences in certain economically distressed areas ("targeted area residences"). A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the State-wide median income or, (2) an area of chronic economic distress. Generally, at least 20 percent of the proceeds of a qualified mortgage issue must be made available for owner-financing of targeted area residences for at least one year. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the mortgages is made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds may be used to finance qualified home-improvement loans and qualified rehabilitation loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on existing residences, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the properties. Under present law, qualified home-improvement loans generally may not exceed $15,000. Qualified rehabilitation loans are loans for rehabilitations of buildings at least 20 years old in which specified portions of the structure are retained and the rehabilitation expenditures represent at least 25 percent of the mortgagor's adjusted basis in the residence.

All or part of the interest subsidy provided by qualified mortgage bonds is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.

Another restriction requires spending the bond proceeds on eligible mortgages within 42 months after the issue date and applying mortgage loan repayments to redeem bonds (rather than to finance additional mortgages) starting 10 years after the issue date.

Volume limitations on private activity bonds

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the "State volume cap"). For calendar year 2013, the State volume cap, which is indexed for inflation, equals $95 per resident of the State or $291,875,000, whichever is greater. Exceptions from the State volume cap are provided for bonds issued for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds that are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

Arbitrage limitations

The interest on a tax-exempt bond becomes taxable if the bond is an arbitrage bond. In general, an arbitrage bond is any bond where a portion of the bond proceeds are reasonably expected to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investments. A second type of general arbitrage limitation requires payment to the United States of certain excess earnings on nonpurpose investments over the yield on the tax-exempt bonds.

In addition to the generally applicable arbitrage rules, mortgage revenue bonds have additional restrictions. In the case of qualified mortgage bonds the effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for the issue rather than on a loan-by-loan basis. Additional rules apply in the case of qualified veterans' mortgage bonds, discussed *infra*.

Mortgage credit certificates

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs").[1360] MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The tax credit provided by the MCC may be carried forward for three years. Once issued, an MCC generally remains in effect as long as the residence being financed is the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC is required to represent a credit for at least 10 percent (but not more than 50 percent) of interest paid or incurred during the taxable year on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000. The three-year carry-forward is not permitted for amounts in excess of the $2,000. The recapture rules for qualified mortgage bonds also apply to MCCs if the homeowner experiences substantial increases in income and disposes of the subsidized residence within nine years of purchase.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of qualifying mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments.

The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local

[1360] Sec. 25.

government for authority to issue MCCs. For example, a State that was authorized to issue $200 million of qualified mortgage bonds, and that elected to exchange $100 million of that bond authority, could distribute an aggregate amount of MCCs equal to $25 million.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are qualified private activity bonds the proceeds of which are used to make mortgage loans to qualified veterans. The Code imposes limitations on qualified veterans' mortgage bonds, including a veterans' residence requirement, a new mortgage requirement, arbitrage restrictions, and a requirement to secure the bonds through a general obligation pledge by the State. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

Mortgage loans can be made to veterans who served on active duty and who applied for the financing before the date 25 years after the last date on which such veteran left active service.

The annual volume of qualified veterans' mortgage bonds that can be issued in California ($340 million) or Texas ($250 million) is based on the average amount of bonds issued in the respective State between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued is $100 million each. Unused allocation cannot be carried forward to subsequent years.

Other Incentives

Qualified first-time homebuyer distributions from an individual retirement plan

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies.[1361] Among other exceptions, the 10-percent early withdrawal tax does not apply to qualified first-time homebuyer distributions from an individual retirement arrangement ("IRA") (including a Roth IRA).

Qualified first-time homebuyer distributions are withdrawals of up to $10,000 during the individual's lifetime that are used within 120 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the individual, the individual's spouse, or a child, grandchild, or ancestor of the individual or individual's spouse. A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the two-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The spouse of the individual must also meet this requirement as of the date the contract

[1361] Sec. 72(t).

is entered into or construction commences. The date of acquisition is the date the individual enters in to a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. For this purpose, principal residence is defined as under section 121 relating to the exclusion of gain from the sale of a principal residence.[1362]

The 10-percent additional tax on early withdrawals is imposed with respect to any amount not used within 120 days of the date of withdrawal. If the 120-day rule cannot be satisfied due to a delay in the acquisition of the residence, the taxpayer may recontribute all or part of the amount withdrawn to a Roth IRA prior to the end of the 120-day period without adverse tax consequences.

Exclusion from income of certain housing allowances and related deductions

Rental value of parsonages

A minister of the gospel's gross income does not include: (1) the rental value of a home furnished as part of his compensation; or (2) the rental allowance paid as part of his compensation, to the extent used to rent or provide a home, and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.[1363]

Military housing allowances

Qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) that: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include the basic allowance for housing authorized under Title 37 U.S.C. section 403.

Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel

Section 265 disallows deductions for expenses allocable to tax-exempt income, such as expenses incurred in earning income on tax-exempt investments. In addition, that provision has been applied in certain cases where the use of tax-exempt income is sufficiently related to the generation of a deduction to warrant disallowance of that deduction. However, section 265 does not apply with respect to parsonage and military housing allowances. That is, no otherwise

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[1362] See discussion above relating to the exclusion of gain from the sale of a principal residence.

[1363] Sec. 107.

allowable deduction is denied for interest paid on a mortgage on, or real property taxes paid on, the home of the taxpayer in the case of (1) a minister of the gospel, on account of a parsonage allowance that is excluded from gross income under section 107, or (2) a member of a military service on account of a military housing allowance. Thus, a minister of the gospel or a member of the military may claim an otherwise allowable deduction for mortgage interest or real property taxes notwithstanding the receipt of a tax-free allowance to purchase the property.

Exclusion from income of discharge of certain qualified principal residence indebtedness

In general

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness.[1364] In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.[1365]

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Qualified principal residence indebtedness

Under a temporary provision, an exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of section 163(h)(3)(B) (relating to the home mortgage interest deduction), except that the dollar limitation is $2 million) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing

[1364] Secs. 61(a)(12) and 108. A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

[1365] Sec. 1017(b)(2).

of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under section 121 of the Code.[1366]

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The basis of the individual's principal residence is reduced by the amount excluded from income under the provision.

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2014.

Treatment of tenant-stockholder of a cooperative housing corporation

A tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent those amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative which are paid or incurred by the cooperative on the cooperative's land or buildings and (2) interest allowable as a deduction to the cooperative that is paid or incurred by the cooperative on its indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, alteration, rehabilitation, or maintenance of the cooperative's buildings.[1367]

A cooperative housing corporation generally is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) the corporation meets one of

[1366] See discussion above relating to the exclusion of gain from the sale of a principal residence.

[1367] Sec. 216.

the following three requirements: (a) 80 percent or more of the corporation's gross income for that taxable year is derived from tenant-stockholders; (b) at all times during that table year 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or (c) 90 percent or more of the expenditures of the corporation paid or incurred during that taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of tenant-stockholders.

2. Tax incentives for residential rental housing

There are also some tax incentives that may reduce the cost of renting relative to owning. These include the low-income housing tax credit, the rehabilitation credit, the exclusion of interest on State and local government qualified private activity bonds for rental housing, accelerated depreciation for rental housing, and exceptions from the passive activity loss rules for rental real estate activities. A description of these provisions follows.

Low-Income Housing Tax Credit

In general

The low-income housing tax credit may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[1368] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

Qualified low-income housing project

To qualify for the low-income housing tax credit, the incomes of the tenants must satisfy certain targeting rules similar to the rules for tax-exempt bond financed qualified residential rental projects. Under the tax credit rules, a project is a qualified low-income housing project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified low-income housing project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The owner must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified low-income housing projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test. In practice many projects have every unit satisfy the income targeting rules so that the entire project qualifies for the credit.

[1368] Sec. 42.

Present value credit

In general

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not Federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is Federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). For example, in a zero interest rate environment, a building eligible for a 70-percent credit would have an annual applicable percentage of 7 percent for each of the ten years of the credit period. As interest rates rise, the 7-percent applicable percentage also rises to preserve the present value of the credit.

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

Special rule

Under a special rule the applicable percentage is set at a minimum of 9 percent for newly constructed non-Federally subsidized buildings placed in service after July 30, 2008 with respect to credit allocations made before January 1, 2014.

Substantial rehabilitation requirement

Rehabilitation expenditures paid or incurred by a taxpayer with respect to a low-income building are treated as a separate building and may be eligible for the 70-percent credit if they satisfy the otherwise applicable credit rules. To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 20 percent of the adjusted basis of the building being rehabilitated; or (2) at least $6,000 per low-income unit in the building being rehabilitated. The $6,000 amount is indexed for inflation so it is $6,400 in 2013.

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (*i.e.*, at least $6,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied. This special rule applies only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit.

Calculation of the applicable percentage

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

These credit percentages (used for the 70-percent credit and 30-percent credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

Enhanced credit for buildings in high-cost areas

Generally, buildings located in three types of high-cost areas (*i.e.*, qualified census tracts, difficult development areas and buildings designated by the State housing credit agency as requiring the enhanced credit in order for such buildings to be financially feasible) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit in qualified census tracts and difficult development areas is that the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of such statistical area. Buildings designated by the State housing credit agency as requiring the enhanced credit in order for such buildings to be financially feasible are not subject to the limitation limiting high cost areas to 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area.

Recapture

The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set aside requirement, or the gross rent requirement, or other requirements with respect to the units comprising the set aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Volume limits

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Generally, the aggregate credit authority provided annually to each State for calendar year 2013 is $2.25 per resident, with a minimum annual cap of $2,590,000 for certain small population States[1369] These amounts are indexed for inflation. Projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit do not require an

[1369] Rev. Proc. 2012-41.

allocation of the low-income housing credit, but the related use of tax-exempt bonds is subject to limitation as described below.

Rehabilitation Tax Credit

Present law provides a two-tier tax credit for rehabilitation expenditures.[1370]

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. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Tax-Exempt Bond Financing for Residential Rental Housing

In general

Private activity bonds are bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes, but is not limited to, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.

Qualified residential rental projects

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project."[1371] A project is a qualified residential

[1370] Sec. 47.

[1371] Sec. 142(d).

rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified residential rental projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

As with most qualified private activity bonds, bonds for qualified residential rental projects are subject to annual State volume limitations (the "State volume cap"). For calendar year 2013, the State volume cap, which is indexed for inflation, equals $95 per resident of the State, or $291,875,000, if greater.

Bonds issued to finance qualified residential rental projects are subject to a term to maturity rule which limits the period of time such bonds may remain outstanding. Generally, this rule provides that the average maturity of a qualified private activity bond cannot exceed 120 percent of the economic life of the property being financed.

Accelerated Depreciation for Residential Rental Housing

Depreciation in general

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under MACRS whereby different types of property generally are assigned applicable recovery periods and depreciation methods.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years.[1372] The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[1373] switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year will yield a larger depreciation allowance. The recovery periods for most real property are 27.5 years (for residential rental property) and 39

[1372] For certain tangible assets, the recovery period is controlled by statute (see, *e.g.*, section I.B.6 of Joint Committee on Taxation, , *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012, which includes a table of statutorily defined recovery periods for specific types of property). For all other tangible assets, the recovery period is generally determined by administrative guidance (see, *e.g.*, Rev. Proc. 87-56, 1987-2 C.B. 674, and Appendix B of IRS Publication 946).

[1373] Declining balance methods accelerate a portion of the total allowable deductions into the earlier years of the recovery period. For example, under the 200-percent declining balance method, the deduction in the first year is twice what it would be under the straight-line method, but the annual allowance amount declines over the recovery period. The allowable amount is thus smaller in the later years than the allowable amounts for those years would have been under the straight-line method.

years (for nonresidential real property). The depreciation method applicable to such real property is straight-line.

Real property

In general

The cost of residential rental property is recovered using the straight-line method of depreciation, and a recovery period of 27.5 years. The cost of nonresidential real property is recovered using the straight-line method, and a recovery period of 39 years. In addition, building improvements and structural components, based on their use, are recovered over either 27.5 years for residential rental property or 39 years for nonresidential real property.

Real property also includes leasehold improvements; however, the assigned recovery period may be longer than the lease term. In general, leasehold improvements are recovered over the same period of time as the property to which the improvement relates (*i.e.*, 27.5 years for residential rental property and 39 years for nonresidential real property).[1374] For certain qualified improvements placed in service before 2014 (*i.e.*, qualified leasehold improvement property,[1375] qualified restaurant property,[1376] and qualified retail improvement property[1377]), the cost of the property is recovered over 15 years, using the straight-line method.[1378] Special rules provide a 15-year recovery period for qualified construction allowances for short-term leases as well.[1379]

Placed in service convention

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention. In the case of both residential rental property and nonresidential real property, a mid-month convention applies. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

[1374] Special rules (*e.g.*, section 165) may permit a deduction of the cost at the end of the lease term.

[1375] Sec. 168(e)(6).

[1376] Sec. 168(e)(7).

[1377] Sec. 168(e)(8).

[1378] Secs. 168(e)(3)(E)(iv), (v), and (ix).

[1379] Sec. 110.

Nondepreciable assets

Certain assets, including land, are not depreciable. The cost of land is recovered only upon sale. Certain improvements to land (*e.g.*, sidewalks, roads, fences, shrubbery) can be depreciated if closely associated with other depreciable property (*e.g.*, residential rental property).[1380]

Depreciation recapture

Depreciable real property, other than that included within the definition of section 1245 property,[1381] disposed at a gain is known as section 1250 property.[1382] Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess of post-1969 depreciation allowances over the depreciation that would have been available under the straight-line method.[1383] However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight-line method. Special rules phase out the recapture for certain types of property held over a specified period of time.[1384]

For corporations, the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property.[1385] For individuals, any capital gain that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property is taxed at a maximum rate of 25 percent.[1386]

[1380] See, *e.g.*, asset class 00.3 of Revenue Procedure 87-56, 1987-2 C.B. 674, that defines land improvements eligible for depreciation.

[1381] Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed at a gain are known as section 1245 property. Sec. 1245(a)(3).

[1382] Sec. 1250(c).

[1383] Sec. 1250(a)(1).

[1384] Sec. 1250(a)(1)(B). The special phaseout rule applies to residential rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k).

[1385] Sec. 291(a)(1).

[1386] Sec. 1(h)(1)(E).

Passive Activity Loss Rules and Special Rental Real Estate Rules

In general

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. 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 disposes of his entire interest in the passive activity in a fully taxable transaction to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Except as provided in regulations, no interest as a limited partner is treated as an interest with respect to which the taxpayer materially participates.

A passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity.

Special rules for rental real estate activities

Rental activities (generally including rental real estate activities) are treated as passive activities, regardless of the level of the taxpayer's participation. However, a special rule treats a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements. To be eligible, (1) more than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. Another special rule permits the deduction of up to $25,000 of losses from rental real estate activities in which the taxpayer actively participates. The $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000.

3. Present law tax treatment of real estate investment

Certain Nonrecognition Events

Like-kind exchanges

In general

An exchange of property, like a sale, generally is a taxable transaction. However, section 1031 provides that no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that is also held for productive use in a trade or business or for investment.[1387] This provision does not apply to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, partnership interests, choses in action, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest,[1388] or to certain exchanges involving livestock[1389] or involving foreign property.[1390]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other property or money, then the gain to the recipient of the other property or money is to be recognized, but not in an amount exceeding the fair market value of such other property or money. Additionally, any gain realized on a section 1031 exchange must be recognized to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250.[1391] No losses may be recognized from a like-kind exchange.[1392]

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.

The basis of like-kind property received in the exchange is the same as the basis of the property that was exchanged. This basis is increased to the extent of any gain recognized due to

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[1387] Sec. 1031(a)(1).

[1388] Sec. 1031(a)(2).

[1389] Sec. 1031(e).

[1390] Sec. 1031(h).

[1391] Secs. 1245(b)(4), 1250(d)(4).

[1392] Sec. 1031(c).

the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.[1393] Thus, in the example 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). 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.[1394]

Deferred like-kind exchanges

A like-kind exchange does not require that the properties be exchanged simultaneously. Rather, the Code requires that the property to be received in the exchange 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).[1395] 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.[1396]

The Treasury Department has issued regulations[1397] providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges. These regulations allow a taxpayer who wishes to sell appreciated property and reinvest the proceeds in other like-kind property to engage in "three-way" exchanges. For example, if taxpayer A wishes to sell his appreciated apartment building and acquire a commercial building, taxpayer A may transfer his apartment building to buyer B. Buyer B (directly or through an intermediary) agrees to purchase from owner C the commercial building that taxpayer A has designated. Buyer B then transfers title to the newly acquired commercial building to taxpayer A, completing the tax-free like-kind exchange. The economics of these transactions (taxes aside) are the same as if taxpayer A had sold the apartment building to buyer B and used the proceeds to purchase the commercial building from owner C. However, a transaction in which the taxpayer receives the proceeds of the sale and subsequently purchases like-kind property would be taxable to the taxpayer under general tax principles.

In order for a three-way exchange to qualify for tax-free treatment, the regulations prescribe detailed rules regarding identification of the replacement property, rules allowing the seller to receive security for performance by the buyer without the seller being technically in receipt of money or other property, and rules relating to whether a person is an agent of the

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[1393] Sec. 1031(d).

[1394] Sec. 1223(1).

[1395] Sec. 1031(a)(3).

[1396] *Ibid.*

[1397] Treas. Reg. sec. 1.1031(k)-1(a) through (o).

taxpayer or is a qualified intermediary whose receipt of money or other property is not attributed to the taxpayer.

Involuntary conversions

In general

Although gain or loss realized from the sale or other disposition of property must generally be recognized, section 1033 of the Code provides an exception to this rule in the case of certain involuntary conversions of property. Section 1033 applies if property is involuntarily or compulsorily converted into similar property or money. Such a conversion may occur as a result of the property's destruction (in whole or in-part), theft, seizure, requisition or condemnation or a sale made under the threat of requisition or condemnation.[1398]

For purposes of section 1033, "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation.[1399] Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or a threat of imminence thereof), and the divestiture is not eligible for deferral under this provision.[1400]

If property is involuntarily converted into property that is similar or related in service or use to the property so converted, no gain is recognized. This treatment is not elective. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. If the taxpayer receives money (for instance, insurance payments or condemnation awards), or other dissimilar property for the involuntarily converted property, and acquires qualified replacement property within the prescribed time period, nonrecognition of the gain is optional.[1401] As a general matter, the prescribed time period begins on the date of the disposition of the converted property (or threat or imminence of a threat of condemnation begins) and ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.[1402]

[1398] Sec. 1033(a).

[1399] Rev. Rul. 58-11, 1958-1 C.B. 273.

[1400] *Ibid*. If the replacement property is stock of a corporation and if the stock basis is decreased under this rule, the aggregate basis of the corporation's assets is likewise decreased by the same amount (but not below that stock basis as so decreased). Sec. 1033(b)(3).

[1401] Sec. 1033(a)(2)(A).

[1402] Sec. 1033(a)(2)(B).

The taxpayer's basis in the replacement property is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.[1403]

For example, if under the threat of condemnation, a taxpayer sells for $35,000 a parcel of land C in which he has an adjusted basis of $25,000, and the taxpayer did not acquire property that is similar or related in service or use to the condemned parcel, the taxpayer would recognize $10,000 in gain. However, if within the prescribed time period described above, the taxpayer acquires a parcel of land D that is similar or related in service or use to C for $35,000, the taxpayer may elect not to recognize the $10,000 in gain from the sale of C. If the taxpayer so elects, his basis in D in would be $25,000, and any gain would be deferred until the taxpayer disposed of D in a recognition transaction. If, on the other hand, the taxpayer had acquired D for only $30,000, even if the taxpayer elected not to recognize gain on the transaction, the taxpayer would nevertheless recognize $5,000 in gain (representing the $5,000 in cash the taxpayer received from the $35,000 sale price of C less the $30,000 purchase price of D). The taxpayer's basis in D would remain $25,000 (having been adjusted upwards by $5,000 to reflect the amount of gain recognized on the conversion, and then having been adjusted downwards by $5,000 to reflect cash received in the conversion). If the taxpayer subsequently sells D for at least $30,000, this would trigger the remaining $5,000 in deferred gain.

Treatment of losses

Section 1033 does not, by its terms, apply to losses realized from the involuntary conversion of property.

Real Estate Investment Trusts ("REITs")

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[1404] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by 5 or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[1405]

[1403] Sec. 1033(b).

[1404] Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[1405] Secs. 856 and 857.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level. Although a REIT is not required to distribute more than the 90 percent of its income described above in order to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed. Section 4981 also imposes an additional four-percent excise tax to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period.

Income tests

In general

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real-estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[1406] Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.[1407] In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income. However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income (the "95-percent income test").[1408]

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[1409]

[1406] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

[1407] Sec. 856(d). Amounts attributable to the provision of certain services by an independent contractor or by a taxable REIT subsidiary can be qualified rents. Sec. 856(d)(7).

[1408] Sec. 856(c)(3).

[1409] See Rev. Rul. 74-191, 1974-1 C.B. 170.

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test"). Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[1410] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[1411]

Except with respect to a taxable REIT subsidiary (described further below), not more than 5 percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[1412] In addition, not more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[1413]

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[1414]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity; however, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent[1415] of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to

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[1410] Sec. 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[1411] Sec. 856(c)(4)(B)(i).

[1412] Sec. 856(c)(4)(B)(iii).

[1413] Sec. 856(c)(4)(B)(ii).

[1414] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

[1415] Twenty-five percent for certain timber REITs for a one-year period. See "Asset tests," *supra*.

provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated. [1416]

However, a TRS may rent a lodging facilty or health care facility from ts parent REIT and is permitted to hire an independent contractor[1417] to operate such facility. Rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facilities operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests. This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests. An exception to the general rule exists in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.[1418]

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business" (sec. 1221(a)(1))[1419] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in sections 857(b)(6)(C) or (D), including an asset holding period of at least two years.[1420] If the conditions are met, a

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[1416] The latter restriction does not apply to rights provided to an independent contractor to operate or manage a lodging or health care facility if such rights are held by the corporation as a franchisee, licensee, or in similar capacity and such lodging facility or health care facility is either owned by such corporation or is leased by such corporation from the REIT.

[1417] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

[1418] REITs are also subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

[1419] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[1420] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the four year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person. Under the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008), the four-year holding period is reduced to two years in the case of a sale of timber property under section 857(b)(1)(D), provided the sale is to a qualified organization (as defined in section 170(h)(3)), exclusively for conservation purposes (as defined in section 170(h)(1)(C). The rule is in place only for taxable years beginning after

REIT may either i) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or ii) sell either no more than 10 percent of the aggregate bases, or no more than 10 percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.

REIT shareholder tax treatment

Although a REIT typically does not pay corporate level tax due to the deductible distribution of its income, and thus is sometimes compared to a partnership or S corporation, REIT equity holders are not treated as being engaged in the underlying activities of the REIT as are partners or S shareholders, and the activities at the REIT level that characterize its income do not generally flow through to equity owners to characterize the tax treatment of REIT distributions to them. A distribution to REIT shareholders out of REIT earnings and profits is generally treated as an ordinary income REIT dividend and is treated as ordinary income taxed at the shareholder's normal rates on such income.[1421] However, a REIT is permitted to designate a "capital gain dividend" to the extent a distribution is made out of its net capital gain.[1422] Such a dividend is treated as capital gain to the shareholders.[1423]

REIT shareholders are not taxed on REIT income unless the income is distributed to them (except in the case of REIT net capital gain retained by the REIT and designated for inclusion in the shareholder's income as explained in the preceeding footnote). However, since a REIT must distribute 90 percent of its ordinary income annually, and typically will distribute or designate its income as capital gain dividends to avoid a tax at the REIT level, REIT income generally is taxed in full at the shareholder level annually.

Because a REIT dividend is paid out of income that was deductible to the distributing REIT entity, the dividend is not eligible for the dividends received deductions to a corporate

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the date of enactment of that Act and before one year following such date of enactment. In addition, for the same one year period, any sale that is exempt from the prohibited transactions provision by virtue of section 857(b)(1)(D) is treated for all purposes of subtitle A of the Code as a sale of property held for investment or use in a trade or business, and not property described in section 1221(a)(1) of the Code.

[1421] Because a REIT dividend is paid out of income that was not taxed to the distributing entity, the dividend is not eligible for the dividends received deductions to a corporate shareholder, nor for the 20 percent qualified dividend rate to an individual shareholder, except to the extent such dividend is attributable to REIT income from nondeductible C corporation dividends.

[1422] Net capital gain is the excess of the net long term capital gain for the taxable year over the net short term capital loss for the taxable year. Sec. 1221.

[1423] A REIT may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT pays corporate-level tax on the capital gain, but the shareholder receives a credit for the corporate level tax paid, with the result that the net tax paid is the shareholder level capital gain tax.

shareholder, nor for the 20 percent qualified dividend rate to an individual shareholder.[1424] A REIT ordinary dividend is treated as ordinary income taxed at the shareholder's normal rates on such income.

REIT shareholders are not entitled to any share of REIT losses to offset against other shareholder income. However, if the REIT itself has income, its losses offset its income in determining how much it is required to distribute to meet the distribution requirements. Also, REIT losses that reduce earnings and profits can cause REIT distributions that exceed its earnings and profits to be treated as a non-taxable return of capital to its shareholders.

Tax exempt shareholders

A tax exempt shareholder is exempt from tax on REIT dividends, and is not treated as engaging in any of the activities of the REIT. As one example, if the REIT borrowed money and its income at the REIT level was debt-financed, a tax exempt shareholder does not have debt-financed unrelated business income from the REIT dividend. This can make real estate investment through a REIT more attractive for tax exempt investors (such as pension funds or university endowments) than investment through a partnership.

Foreign shareholders

Except as provided by the Foreign Investment in Real Property Tax Act (FIRPTA)[1425] a REIT shareholder that is a foreign corporation or a nonresident alien individual normally treats its dividends as fixed and determinable annual and periodic income that is subject to withholding under section 1441 but not treated as active business income that is effectively connected with the conduct of a U.S. trade or business, regardless of the level of real estate activity of the REIT in the United States.[1426] A number of treaties permit a lower rate of withholding on REIT dividends than the Code would otherwise require.

Some U.S. income tax treaties that apply a reduced withholding tax rate to dividend distributions contain special provisions for distributions that are treated as ordinary dividends from REITs or RICs. These treaties generally restrict the withholding tax rate reduction for such dividends to no lower than 15 percent. In the case of REITs, they also limit qualification for the 15-percent rate to foreign shareholders that own no more than a specified percentage of the REIT. The percentage varies depending on whether the REIT stock is held by an individual (generally 10 percent, sometimes more, *e.g.*, 25 percent), or is held by any person in a diversified REIT (generally 10 percent) or, if neither of the other exceptions applies, generally five percent

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[1424] To the extent a REIT dividend is attributable to a dividend from a C corporation, however, it is eligible for such treatments in the hands of shareholders.

[1425] A general discussion for FIRPTA appears under a separate heading.

[1426] As noted above, REITs are not permitted to receive income from property that is inventory or that is held for sale to customers in the ordinary course of the REIT's business. However, REITs may engage in certain activites, including acquisition, development, lease, and sale of real property, and may provide "customary services" to tenants.

in the case of dividends paid with respect to a class of publicly traded stock.1427 Some treaties further provide an exception to these shareholder ownership limits to permit certain publicly traded investment entities of the other country to own more REIT stock than the otherwise applicable limit.1428 Under some such treaties, however, the shareholder REIT ownership limitations are applied separately, on a "look-through" basis, to any shareholder that the other country entity knows or should know owns more than five percent of such entity.1429

Although FIRPTA applies in many cases to foreign investment in U.S. real property through a REIT, REITs offer foreign investors some ability to invest in U.S real property interests without subjecting gain on the sale of REIT stock to FIRPTA (for example, if the REIT is domestically controlled). Also, if the REIT stock is publicly traded and the foreign investor does not own more than 5 percent of such stock, the investor can receive distributions from the sale by the REIT of U.S. real property interests, without such distributions being subject to FIRPTA.[1430]

Real Estate Mortgage Investment Conduits

A REMIC is a fixed pool of mortgages with multiple classes of interests held by investors.[1431] In general, if the specified requirements are met, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein under specified rules.[1432] Holders of "regular interests" generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular

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[1427] See, *e.g.*, Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, August 6, 1982, as amended by the Protocol signed on September 27, 2001, article 10(4) ("U.S.-Australia Treaty") (certain REIT ownership interests existing before the date of the protocol are entitled to the 15-percent dividend rate without regard to the ownership limitations); see also Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, December 18, 1992, as amended by the Protocol signed on March 8, 2004, article 10(4) ("U.S.-Netherlands Treaty"); Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland, as amended by the Protocol signed on July 24, 2001, article 10(4) ("U.S.- U.K. Treaty").

[1428] See, *e.g.*, the U.S.- Australia Treaty and the U.S.- Netherlands Treaty, supra.

[1429] See, *e.g.*, the U.S.-Australia Treaty, supra.

[1430] The special rules for REITs and certain RICs are discussed in more detail in the section entitled "Foreign Investment in Real Property Tax Act ("FIRPTA").

[1431] Sec. 860D.

[1432] Sec. 860A.

interest;[1433] holders of "residual interests" take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests.[1434]

A regular interest in a REMIC is an interest in a REMIC whose terms are fixed on the startup day, which terms (1) unconditionally entitle the holder to receive a specified principal (or similar) amount, and (2) provide that interest (or similar) payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in regulations, a variable rate). An interest in the REMIC may qualify as a regular interest where the timing (but not the amount) of the principal (or similar) payments are contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments. A residual interest is an interest in a REMIC which is issued on the startup date, is not a regular interest, and is designated as a residual interest.[1435]

A REMIC generally consists of a fixed pool of mortgages that wastes away as the mortgages are paid, and the proceeds are distributed to holders of regular and residual interests. To qualify as a REMIC substantially all of the assets of the entity must consist of qualified mortgages and permitted investments. Qualified mortgages are, with limited exceptions, limited to mortgages that are transferred to the REMIC on the startup date.

Modifications of existing mortgages are generally treated as dispositions of the original mortgage if the modifications are significant. If there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate that qualification if the modifications cause less than substantially all of the entity's assets to be newly acquired, and thus not qualifying, mortgages.

Certain loan modifications, however, are not significant for purposes of the REMIC provisions, even if the modifications are significant under the regular gain recognition rules set forth in Code section 1001.[1436] For example, if a change in the terms of an obligation is occasioned by default or a reasonably foreseeable default, the change is not a significant modification for purposes of the REMIC provisions.

In addition, penalties are imposed on prohibited transactions. Prohibited transactions include the disposition of a qualified mortgage, other than dispositions incident to foreclosure, default or imminent default, or the receipt of income from assets other than permissible assets.

[1433] Sec. 860B.

[1434] Sec. 860C.

[1435] Sec. 860G.

[1436] Treas. Reg. sec. 1.860G-2(b)(3).

If a qualifying mortgage is disposed of in a prohibited transaction, a 100 percent tax is imposed on net income from the disposition.[1437]

Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")

In general

A foreign person that is not engaged in business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources.[1438]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[1439] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[1440] 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 effectively-connected with a U.S. trade or business ("FIRPTA income") to a foreign person is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[1441] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and stock of a domestic U.S. real property holding company ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real

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[1437] Sec. 860F.

[1438] Secs. 871(b), 882(a).

[1439] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

[1440] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[1441] Sec. 1445 and Treasury regulations thereunder. The Treasury department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during the shorter of the taxpayer's ownership of the stock or the five-year period ending on the date of disposition of the stock.[1442] However, any class of stock that is regularly traded on an established securities market is treated as a USRPI only if the seller held more than five percent of the stock at any time during such period.[1443]

Under these rules, for example, if a foreign person directly owns U.S. real estate, or owns U.S. real estate through a partnership, gain from the sale of the real estate will be subject to tax as FIRPTA income.[1444] Alternatively, if a foreign person owns U.S. real estate through a corporation that is a USRPHC that is not publicly traded, (or owns more than five percent of the stock of a publicly traded USRPHC during the relevant period) gain from sale of the corporate stock is generally subject to tax as FIRPTA income.

Special rules for certain investment entities (REITs and RICs)[1445]

Certain investment entities

REITs and RICs are generally passive investment entities (though certain activities are permitted). They are organized as U.S. domestic entities and are taxed as U.S. domestic corporations. However, because of their special status, they are entitled to deduct amounts distributed to shareholders and, in some cases, to allow the shareholders to characterize these amounts based on the type of income the REIT or RIC received. Among numerous other requirements for qualification as a REIT or RIC, such entities are generally required to distribute to shareholders at least 90 percent of their income (excluding net capital gain) annually.[1446] A REIT or RIC may designate a capital gain dividend to its shareholders, who then treat the amount designated as capital gain.[1447] A REIT or RIC is taxed at regular corporate rates on undistributed income; but the combination of the requirement to distribute income other than net capital gain, plus the ability to declare a capital gain dividend and avoid corporate level tax on such income, typically results in little, if any, corporate-level tax paid by a REIT or RIC. Instead, the shareholder-level tax on distributions is the principal tax paid with respect to income of these entities. The requirements for REIT eligibility include primary investment in real estate assets (which assets can include mortgages). The requirements for RIC eligibility include primary investment in stocks and securities (which can include stock of REITs or of other RICs).

[1442] Secs. 897(c)(1)(A)(ii), 897(c)(2).

[1443] Sec. 897(c)(3). Constructive ownership rules apply under section 897(c)(6)(C).

[1444] See also, Rev. Rul. 91-32, 1991-1 C.B. 107.

[1445] Sec. 897(h).

[1446] Secs. 852(a)(1), 852(b)(2)(A), 857(a)(1). If a REIT or RIC does not distribute net capital gain (or deem it to be distributed), a corporate level tax is imposed on the retained income. Additional distribution requirements are imposed under section 4981 (for REITs) and section 4982 (for RICs).

[1447] Secs. 852(b)(3), 857(b)(3).

FIRPTA rules for REITs and RICs

Certain special rules under FIRPTA apply to REITs, and to certain RICs that are largely invested in U.S. real property interests. REITs and such RICs are called "qualified investment entities".[1448] Stock of a "domestically controlled" qualified investment entity is excluded from the definition of a USRPI.[1449] The term "domestically controlled" is defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant holding period, generally the five-year period ending on the date of a disposition or distribution to which the exception applies.[1450] Thus, stock of a domestically controlled REIT or of a domestically controlled RIC that is a qualified investment entity for this purpose can be sold without FIRPTA consequences. This exception applies regardless of whether the sale of stock is made directly by a foreign person, or by a REIT or RIC whose distributions to foreign persons of gain attributable to the sale of USRPIs would be subject to FIRPTA.

A distribution by a qualified investment entity to a foreign shareholder, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is generally treated as FIRPTA income to the shareholder. The FIRPTA character is also retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[1451] An IRS notice states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to both nonliquidating and liquidating distributions to a qualified investment entity shareholder and that the IRS will issue regulations to that effect.[1452] An exception to this rule applies if the distribution is made on a class of qualified investment entity stock that is regularly traded on an established securities market located in the United States and the foreign person has not held more than five percent of the class of stock at any time during the

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[1448] A "qualified investment entity" means any REIT. It also includes, for purposes of the special rules, any RIC which is a USRPHC or which would be a USRPHC if the exceptions provided in sections 897(c)(3) (regarding five-percent shareholders of publicly traded entities) and 897(h)(2) (regarding domestically controlled entities) did not apply to interests in any RIC or REIT. After December 31, 2011, a RIC is not included in the definition for purposes of the rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

[1449] Sec. 897(h)(2).

[1450] Sec. 897(h)(2), (h)(4)(B). For 2005 through 2011, a similar exception applies to RIC stock if the RIC meets specific asset requirements taking into account its investment in REITs. Sec. 897(h)(4)(A)(ii).

[1451] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222 sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[1452] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt from tax under section 892. The Notice cites and compares pre-existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp.Treas.Reg. secs. 1.892-3T, 1.897-9T(e), 1.1445-10T(b).

one-year period ending on the date of the distribution.[1453] Where the exception applies, a distribution to the foreign shareholder is treated as the distribution of an ordinary dividend (rather than as a capital gain dividend), subject to 30-percent (or lower treaty rate) withholding. Such a dividend distribution is not exempt from U.S. tax as capital gain, but also is not treated as FIRPTA income that would require a U.S. tax return to be filed.[1454]

[1453] Sec. 897(h)(1).

[1454] Sec. 857(b)(3)(F). Based on statutory references to section 857(b)(3)(B) and (D), which refer to capital gain dividends, an IRS Chief Counsel Attorney Memorandum concludes that no tax is imposed in the case of a liquidating distribution to such a shareholder that would not be treated as a dividend to the shareholder. The treatment provided under Notice 2007-55 to investors not qualifying for the publicly traded five-percent shareholder rule is also reiterated in the memorandum. IRS AM 2008-003.

K. Present Law: Small Businesses/Pass Throughs

1. Overview

The vast majority of businesses in the United States are organized for tax purposes as sole proprietorships. In 2009, there were more than 22.6 million nonfarm sole proprietorships out of 33.6 million total business returns. There were approximately 1.7 million C corporations, 1.9 million farms, 3.1 million partnerships, and 4.1 million S corporations. The number of passthrough entities surpassed the number of C corporations in 1987 and has nearly tripled since then, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies ("LLCs") taxed as partnerships.

Owners of business enterprises historically have chosen to incorporate a business for various nontax reasons. One reason has been that corporate form generally shields the shareholders from liabilities of the business. Another has been that corporate stock may be issued in public markets for access to capital.

A passthrough entity such as a partnership or S corporation, however, may be preferred for Federal tax reasons. A primary reason is that no Federal income tax normally applies at the entity level in the case of a passthrough entity. Rather, items of income, gain, or loss are taken into account for tax purposes by the partners or S corporation shareholders on their own tax returns. By contrast, a C corporation (which is not a passthrough entity) is taxed separately on its income, and shareholders are taxed separately on distributions by the corporation. Other Federal tax rules may give rise to incentives (or disincentives) to select a particular type of entity through which to conduct a business.[1455]

These incentives have resulted in disputes between the Internal Revenue Service ("IRS" or the "Service") and taxpayers about the proper classification of business entities for Federal tax purposes. Case law and Treasury regulations have addressed whether an entity is properly treated as a C corporation subject to entity-level tax, or as another type of entity such as a partnership.

From the 1950s to 1996, the determination of whether a business entity was a C corporation or a partnership was governed by case law and by 1960 regulations[1456] that set forth factors considered indicative of corporate status. These corporate characteristics are (1) continuity of life, (2) centralization of management, (3) limited liability for owners of the entity, and (4) free transferability of interests. An unincorporated entity was classified as a partnership if it lacked any two or more of the four corporate characteristics.

[1455] A number of present law provisions affecting small businesses such as expensing under section 179, deduction of start-up and organizational expenditures under sections 195, 248 and 709, tax accounting rules under sections 448 and 471, etc. are relevant to manufacturers and are described above in section H.

[1456] Former Treas. Reg. sec. 301.7701-2. These were known as the Kintner regulations because they were based on the analysis in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954). See also *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-2 C.B. 1.

Entity classification issues are not especially relevant to S corporations, passthrough entities which came into being in 1958 Federal tax legislation. S corporation status is open to a domestic corporation, requires an affirmative election, and is subject to specific requirements as to number and nature of shareholders, class of stock, and other characteristics. These features make identification of an entity as an S corporation relatively unambiguous.

In late 1996, the IRS adopted new entity classification regulations known as the check-the-box regulations. These regulations allow tax classification as either a partnership or a corporation to be explicitly elective subject to minimal restrictions for any domestic nonpublicly traded unincorporated entity with two or more members. The check-the-box regulations also provide that a single-member unincorporated entity may be disregarded for Federal tax purposes, that is, treated as not separate from its owner.

The 1996 regulations did not, however, alter the statutory rules enacted in 1987 treating publicly traded partnerships as C corporations to address concern about long-term erosion of the corporate tax base. A publicly traded partnership generally is treated as a C corporation for Federal tax purposes, unless 90 percent or more of its gross income is qualifying income.

The existence of two principal categories of business entities with different Federal income tax treatment raises several types of policy questions. What are the effects of individual and corporate income tax rates on taxpayers' choices of business entities? On what basis is it appropriate to distinguish between a C corporation and a passthrough entity for Federal tax purposes? Are there factors that better reflect tax or nontax policy reasons for the distinction between corporations and passthrough entities that are in addition to, or instead of, the present-law statutory and regulatory rules? Would a uniform passthrough regime be simplifying?

2. Choice of business entity

C Corporations

In general

A C corporation is subject to Federal income tax as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends[1457] to its shareholders. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed directly through to shareholders.

Corporate income that is not distributed to shareholders generally is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected

[1457] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates. Sec. 301(c).

in an increased share value, the shareholder may be taxed at capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[1458] Foreign investors generally are exempt from U.S. income tax on capital gains, but are subject to withholding tax on dividends. Tax-exempt investors generally are not subject to tax on corporate distributions or on sales or exchanges of corporate stock.

The gain on appreciated corporate assets generally is subject to corporate level tax if the assets are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

Deductible and nondeductible payments

In general, amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation,[1459] and are taxed as ordinary income at the individual level (unless a specific exclusion applies). On the other hand, amounts paid as dividends to shareholders generally are not deductible by the corporation and are taxed as income to the shareholders (generally at the same preferential rates as apply to capital gains).[1460] However, amounts paid to corporate shareholders as dividends generally are eligible for a dividends-received deduction for the recipient corporation that results in the recipient corporation being taxed on at most 30 percent and possibly on none of the dividend received by the shareholder.[1461]

Treatment of equity and debt holders

Investors in a C corporation receive different treatment depending upon whether an instrument is characterized as equity or debt for tax purposes.[1462] Also, at the entity level, in

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[1458] If stock is held until the death of the shareholder, the heirs are given a fair market value basis in the stock at death, resulting in no shareholder level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption (*i.e.*, a sale of their stock to the corporation).

[1459] Annual compensation in excess of $1 million that is payable to the chief executive officer or the three other most highly compensated employees of a public corporation is not deductible unless the compensation qualifies as performance-based compensation or another exception applies. Sec. 162(m); IRS Notice 2007-49, 2007-25 I.R.B. 1429.

[1460] Sec. 1(h)(11).

[1461] Sec. 243. The recipient corporation generally can claim a 100 percent dividends-received deduction if the recipient corporation owns 80 percent or more of the distributing corporation. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent.

[1462] Debt and equity investments also provide different consequences to certain types of investors in the passthrough regimes of partnerships and S corporations. For example, tax-exempt and foreign investors generally are not taxed on interest income from a partnership if they are debt investors, but generally are taxed on their share of partnership income from business activity of the partnership if they are equity investors. The S corporation rules do not permit certain tax-exempt investors or foreign investors to own stock of an S corporation. Those tax-exempt

general, interest paid by a C corporation is deductible but dividends paid are not.[1463] The latter rule (especially when coupled with the ability of many tax-exempt or foreign investors to exclude interest income) creates a tax incentive that generally favors debt over equity in a corporation's capital structure. However, in some special situations, equity may be preferred to debt. For example, an issuing corporation with losses may prefer to issue preferred stock with characteristics similar to debt, effectively passing through some of the benefit of its losses to shareholders.[1464] Foreign shareholders may prefer either dividend or interest income, depending on the tax treatment in their country of residence and the applicable U.S. corporate income tax and withholding tax rates.

Shareholders receive different treatment depending on whether a corporate equity distribution is characterized as a dividend or as a payment in exchange for stock that is entitled to both capital gain treatment and basis recovery. While the individual tax rates for dividends and capital gains on stock generally are the same under present law, capital gain treatment permits basis recovery.[1465] A number of Code provisions have attempted to provide guidance in this area. For example, section 302 provides rules to determine whether a shareholder whose stock has been partially redeemed has experienced a sufficient contraction in his or her interest to be treated as having sold the stock rather than as having received a dividend. Section 304 provides additional rules intended to deal with sales of stock to commonly controlled corporations.

Consolidated returns of affiliated groups of corporations

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns.[1466] A condition of electing to file a consolidated return is that all corporations that are members of the affiliated group must consent to all the consolidated return regulations prior to the last day prescribed by law for filing the consolidated return. The Treasury

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investors that may own S corporation stock, with the exception of employee stock ownership plans, are subject to an unrelated business income tax on their share of S corporation income. These factors can lead to a preference for structuring partnership or S corporation investment by such investors as debt.

[1463] If certain requirements are satisfied, dividends paid on stock held by an employee stock ownership plan are deductible by the corporation. Sec. 404(k).

[1464] Distributions to shareholders by a loss corporation are taxed as dividends, with accompanying dividend treatment to shareholders, if the loss corporation had prior year earnings and profits that have not yet been distributed. If all earnings and profits have been distributed, distributions to shareholders would be nontaxable return of capital distributions, reducing the shareholders' basis in the stock.

[1465] Foreign shareholders, in addition, may not be subject to tax on capital gains, though they are taxed (often at a reduced rate under tax treaties) on dividends. On the other hand, some corporate shareholders may prefer dividend treatment if they are eligible for the dividends-received deduction.

[1466] Sec. 1504. An affiliated group for this purpose includes a parent corporation that directly owns 80 percent of the vote and value of the stock (excluding certain nonvoting preferred stock) of at least one subsidiary (causing that subsidiary to be a qualified member of the group) and other corporations of which qualified upper tier members in turn hold such stock ownership. Foreign corporations and certain other entities are not eligible to be members of such a group.

department has issued extensive consolidated return regulations under its authority to provide such rules. The regulations generally are directed toward preventing double taxation of income earned within the group, while preserving tax attributes if assets or corporations that were members leave the group and preventing avoidance of tax due to shifting of attributes in the course of intragroup transactions.[1467]

A C corporation often is the entity of choice if a corporation anticipates a public offering, because publicly traded partnerships generally are taxed as corporations,[1468] and S corporations (discussed below) are not permitted to have more than 100 shareholders.[1469]

Personal holding companies

In addition to the regular corporate income tax, the Code provides for taxes designed to prevent retention of corporate earnings so as to avoid individual income tax. The personal holding company tax is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items.[1470] Additional special rules affecting the corporate tax rates are described below.

Partnerships

Federal income tax treatment of partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the entity level.[1471] Items of income (including tax-exempt income),

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[1467] Sec. 1502.

[1468] Sec. 7704. As discussed below, an exception from the general rule whereby publicly traded partnerships are taxed as corporations is provided under section 7704(c). This exception permits publicly traded partnerships, at least 90 percent of whose gross income is qualifying income (*i.e.,* interest, dividends, real property rents, certain gains and other income specified in section 7704(d)) to be taxed as a passthrough entity.

[1469] In some circumstances, it is possible that nonpublicly traded entities also might choose to operate as C corporations, for example to obtain the benefit of a separate corporate rate bracket or the benefit of special corporate treatment (*e.g.*, the dividends-received deduction) for earnings that are to be retained in the corporation. Appreciation in corporate assets generally is subject to corporate level tax when the assets are distributed to shareholders, and there is no lower rate for corporate capital gains. These factors generally would be a deterrent to placing assets into a C corporation. Nevertheless, there may be situations where lower effective corporate rates could provide benefits. For a more detailed discussion of debt and equity, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, and see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

[1470] Secs. 541-547. In addition, the accumulated earnings tax can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business. However, the rate is 20 percent. Secs. 531-537.

[1471] Sec. 701.

gain, loss, deduction, and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[1472] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.[1473] To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and nondeductible expenditures not properly chargeable to capital account, and (2) any partnership distributions.[1474]

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.[1475] In general, an allocation is permitted 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.

Limited liability companies

In the last 35 years,[1476] States have enacted laws providing for another form of entity, the limited liability company ("LLC"). LLCs are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners for obligations of the business. LLCs are treated as partnerships for Federal tax purposes, unless an election is made to be treated as a corporation. Under regulations promulgated in 1996, any domestic unincorporated entity with two or more members that is not publicly traded is treated as a partnership under the default rules but may elect to be treated as a corporation for Federal income tax purposes, and any single-member unincorporated entity is disregarded (*i.e.*, treated as not separate from its owner)[1477] for Federal income tax purposes under the default rules (though

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[1472] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership to cover the tax liabilities of individual partners.

[1473] 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.

[1474] Sec. 705.

[1475] Sec. 704.

[1476] 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.

[1477] Thus, if the single member is an individual, such a disregarded LLC is treated as a sole proprietorship. If the single member is a corporation, the LLC is treated as a division or branch.

it may elect to be treated as a corporation).[1478] These regulations, known as the check-the-box regulations, were a response, in part, to the growth of LLCs.[1479]

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.[1480] 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).[1481]

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.[1482] However, this exception does not apply to any partnership 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[1483] as a management company or unit investment trust.[1484]

Section 7704(d) defines qualifying income 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. Qualifying income also includes rents from real property, gain from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool)

[1478] Treas. Reg. sec. 301.7701-3.

[1479] The check-the-box rules are discussed in more detail below. More recently, some State law has provided for so-called series LLCs (the first was Delaware in 1996, Del. Code Ann. Title 6, section 18-216). Treasury regulations have been proposed that address the tax treatment of series LLCs and domestic cell companies created under applicable State law (as well as certain foreign series or cells). The proposed regulations set forth criteria for determining whether the series or cell is treated as an entity for Federal tax purposes. See REG-119921-09, September 14, 2010. The proposed regulations define a series as "a segregated group of assets and liabilities that is established pursuant to a series statute…by agreement of a series organization…." Prop. Treas. Reg. sec. 301.7701-1(a)(5)(C).

[1480] Sec. 7704(a). The reasons for change stated by the Ways and Means Committee when the provision was enacted provide in part: "[t]he recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base." H.R. Rep. 100-391, Omnibus Reconciliation Act of 1987, October 26, 1987, p. 1065.

[1481] Sec. 7704(b).

[1482] Sec. 7704(c)(2).

[1483] Pub. L. No. 76-768 (1940).

[1484] Sec. 7704(c)(3).

where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts.

S Corporations

In general

An S corporation provides the Federal income tax advantage of passthrough treatment while retaining the nontax advantages of corporate status under Federal securities laws and State law. An S corporation and its shareholders generally are treated, for Federal income tax purposes, more like a partnership and its partners than like a C corporation and its shareholders. To make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity and number of its shareholders.

Limitations on number and type of shareholders and class of stock

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.[1485] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[1486] Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership). Certain corporations may not elect S corporation status including financial institutions using the reserve method of accounting for bad debts and insurance companies subject to tax under subchapter L.[1487]

Passthrough of income and losses to S corporation shareholders

For Federal income tax purposes, an S corporation generally is not subject to tax at the corporate level.[1488] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account in computing the tax of the shareholders (under 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 the S corporation stock and the indebtedness of the S corporation

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[1485] Sec. 1361. For this purpose, a husband and wife and all members of a family (and their estates) are treated as one shareholder. Under this rule, members of a family means a common ancestor and any lineal descendant up to six generations removed, and the spouse or former spouse of the common ancestor or lineal descendant. Sec. 1361(c)(1).

[1486] Sec. 1362.

[1487] Sec. 1361(b)(2).

[1488] Secs. 1363 and 1366.

to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased (in the case of stock) by the shareholder's share of the S corporation's income and contributions to capital.[1489]

S corporations that were previously C corporations

There are two principal exceptions to the general passthrough treatment of S corporations. Both are applicable only if the S corporation was previously a C corporation and generally are intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.[1490] Second, if a C corporation elects to be an S corporation (or transfers assets to an S corporation in a carryover basis transaction), certain net built-in gains that are attributable to the period in which it was a C corporation, and that are recognized during the first 10 years (five years for taxable years before 2014) in which the former C corporation is an S corporation, are subject to corporate-level tax.[1491]

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, or unless the S corporation was formerly a C corporation and has undistributed earnings and profits.[1492] To the extent of such earnings and profits, corporate distributions are treated as dividends of C corporations and generally are subject to tax as such in the hands of the shareholders.

Comparison of Features of Partnerships and S Corporations

Notwithstanding that they both provide for passthrough treatment, there are several significant Federal tax differences between S corporations and partnerships. First, corporate liabilities (other than those owed to its shareholders) are not included in a shareholder's basis of an interest in an S corporation, whereas a partner's share of partnership-level debt generally is taken into account. However, unlike a partner in a partnership, an S corporation shareholder's limitation on corporate deductions looks to the shareholder's adjusted basis in both S corporation

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[1489] Sec. 1367.

[1490] Sec. 1375. Subchapter C earnings and profits generally refers to the earnings of the corporation prior to its subchapter S election which would have been taxable as dividends if distributed to shareholders by the corporation prior to its subchapter S election. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated. Sec. 1362(d)(3).

[1491] Sec. 1374. The period was seven years for taxable years beginning in 2009 and 2010, and five years for taxable years beginning in 2011, 2012, and 2013.

[1492] Sec. 1368.

stock and indebtedness of the S corporation to such shareholder. Thus, S corporation shareholders might be able to substitute shareholder-level debt for entity-level borrowing and contribute or re-lend such amounts to the S corporation to provide basis (in the shareholder's stock or debt) against which to take entity losses.

Further, S corporations may have only one class of stock and, thus, do not offer the same flexibility as partnerships to allocate income and losses among investors. In addition, if a tax-exempt entity (including any individual retirement account or qualified retirement plan) is an equity investor in a partnership, its share of business income of the partnership is subject to unrelated business income tax. An S corporation likewise generally is not permitted to have a tax-exempt shareholder that is not subject to unrelated business income tax on S income, except that an employee stock ownership plan ("ESOP") is permitted to be a shareholder in an S corporation without unrelated business income tax.[1493]

An S corporation, unlike a partnership, permits a C corporation to convert to a passthrough form without immediate recognition of gain at either the corporate or the shareholder level. Since 1986, the liquidation of a C corporation has required the corporation to recognize gain on its assets. A conversion of a C corporation to a partnership is treated as a liquidation of the C corporation. However, conversion of a C corporation to an S corporation is achieved through electing S status without immediate tax consequences, rather than by liquidating the corporation in a taxable transaction. Certain built-in gain and built-in income items of the C corporation that elects S status remain subject to C corporation tax if recognized within 10 years (five years for taxable years before 2014) after the conversion. Thus, if a C corporation can satisfy the limit on the number and type of shareholders, the single class of stock requirement, and other requirements for S corporation status, a conversion of a C corporation to the S corporation passthrough form is not taxable, and all post-conversion income and appreciation of assets in the entity are subject only to shareholder level tax.

Table 24 lists the principal differences in the taxation of the two types of entities and their owners.

[1493] Sec. 512(e)(3).

Table 24.–Principal Differences in Taxation of Partnerships and S Corporations

Item	Partnerships	S Corporations	C Corporations
Maximum number of equity interests	No maximum number. Partnerships with over 100 partners may elect a special passthrough regime.[1494]	Maximum number of shareholders is 100. Family members treated as one shareholder for this purpose.	No maximum number.
Classes of equity interests	No limitation.	One class of stock. Voting rights are disregarded in making this determination.	No limitation.
Ineligible entities	Generally, partnerships with equity interests that are publicly traded.	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; DISCs and former DISCs.	None.
Eligible shareholders	All persons eligible.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans.	All persons eligible.

[1494] See secs. 771-777 and 6240-6255 for treatment of electing large partnerships.

Item	Partnerships	S Corporations	C Corporations
Foreign taxpayers	Eligible to be a partner; certain income subject to withholding tax.	Ineligible to be a shareholder.	Eligible to be a shareholder; effectively connected income subject to withholding tax; dividends subject to withholding tax with possible reduced treaty rate; generally no tax on sale of stock unless effectively connected income.
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income.	Eligible to be a shareholder; dividend generally not subject to unrelated business income tax.
Trusts	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.	Eligible to be a shareholder; usual trust taxation rules apply.
Allocation of income and losses	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect.	Pro rata among shares on a daily basis.	Not applicable.

Item	Partnerships	S Corporations	C Corporations
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis.	Losses deductible against corporate income; NOLs generally can be carried back two years and forward 20 years; capital losses generally can be carried back three years and forward five years.
Contributions of property to entity	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special rules allocating built-in gain or loss to contributor.	Tax-free if transferors are in control of the company after the exchange; possible exception where contributed property is subject to debt.
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner.	Gain taxed to corporation; fair market value basis to shareholder; no basis adjustments to corporate property.	Any gain in distributed property taxable to the corporation; shareholder taxed if amount of distribution exceeds stock basis.
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-through provision; no adjustments to basis of corporate property.	Gain treated as capital.

Item	Partnerships	S Corporations	C Corporations
Termination of entity	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.	Generally taxable to both corporation and shareholders.
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 10 year period after election effective (special rules in 2009, 2010, and 2011 shortened the period); distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.	Not applicable.
Mergers and other reorganizations with corporations	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.	Generally tax-free.
Corporate tax rules of subchapter C	Rules inapplicable.	Rules generally applicable.	Rules applicable.
Wholly owned corporation	Corporation treated as separate entity.	Wholly owned subsidiary corporation may elect to be treated as part of parent S corporation.	Not subject to tax on dividends or liquidating distributions paid between wholly-owned subsidiaries.

Item	Partnerships	S Corporations	C Corporations
Application of employment (OASDI and HI) taxes	Except in the case of a limited partner, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation to a shareholder-employee are wages; no amounts are net earnings from self-employment.	Amounts paid as compensation are wages; no amounts are net earnings from self-employment.

Other Entities

In general

In addition to partnerships and S corporations, present law provides for several other types of entities that generally are not taxed at the entity level.[1495] However, those that allow public shareholders to invest in a vehicle that is not subject to entity-level tax generally are subject to restrictions regarding their structure, nature of income, nature of assets, and ownership of other entities.[1496] Additionally, some of the restrictions limit the potential for extracting earnings of a taxable corporation as deductible amounts that reduce corporate-level tax when paid to the nontaxed entity.

Trusts

Regulations governing the classification of entities as trusts or corporations provide that trusts generally do not have associates (for example, shareholders) or an objective to carry on business for profit.[1497] Thus, a trust generally cannot conduct an active business of any kind, nor can it engage in the purchase and sale of assets for profit.

A grantor trust is a trust whose grantor has retained the right to exercise certain powers over the trust.[1498] A grantor trust is not treated as a separate taxable entity. Instead, the grantor is treated as the owner of the trust's property and is subject to tax on trust income.

Regulated investment companies

In general, a regulated investment company ("RIC") is an electing domestic corporation that either meets, or is excepted from, registration requirements under the Investment Company Act of 1940,[1499] that derives at least 90 percent of its ordinary income from specified sources considered passive investment income,[1500] that has a portfolio of investments that meet certain diversification requirements,[1501] and meets certain other requirements.[1502]

[1495] The mechanisms for eliminating tax at the entity level differ among the types of entities. In general, the entities are referred to herein as nontaxed entities. They do not all pass through the character of the income received, and some are subject to corporate level tax to the extent they do not either distribute their income or designate undistributed income as currently taxable to their beneficial interest holders.

[1496] For example, these limits reduce the potential for indirectly deriving nonpermitted types of income through a related or controlled entity.

[1497] See Treasury Regulations under section 641.

[1498] See section 671.

[1499] Secs. 851(a) and (b)(1).

[1500] Sec. 851(b)(2).

[1501] Sec. 851(b)(3).

Many RICs are "open-end" companies (mutual funds) which have a continuously changing number of shares that are bought from, and redeemed by, the company and that are not otherwise available for purchase or sale in the secondary market. Shareholders of open-end RICs generally have the right to have the company redeem shares at net asset value. Other RICs are "closed-end" companies, which have a fixed number of shares that normally are traded on national securities exchanges or in the over-the-counter market and that are not redeemable upon the demand of the shareholder.

In the case of a RIC that distributes at least 90 percent of its net ordinary income and net tax-exempt interest to its shareholders, a deduction for dividends paid is allowed to the RIC in computing its tax.[1503] Thus, no corporate income tax is imposed on income distributed to its shareholders. Dividends of a RIC generally are includible in the income of the shareholders; a RIC can pass through the character of (1) its long-term capital gain income, by paying "capital gain dividends"[1504] and (2) in certain cases, tax-exempt interest, by paying "exempt-interest dividends." A RIC also may pass through certain foreign tax credits and credits on tax-credit bonds, as well as the character of certain other income received by the RIC.

Although a RIC is not required to distribute more than the 90 percent of its income described above in order to retain RIC status, it is taxed at ordinary corporate rates on amounts not distributed. Section 4982 also imposes an additional four-percent excise tax to the extent a RIC does not distribute at least 98 percent of RIC ordinary income and 98.2 percent of RIC capital gain net income within a calendar year period.

If RIC stock is "stapled" to the stock of another entity (such that an interest in one changes hands together with the interest in the other) and if such "stapled" stock represents more than 50 percent in value of the beneficial ownership of each of the entities, then the two entities are treated as one.[1505] These rules limit the degree to which the shareholders of the RIC may derive income that would not be qualifying income for the RIC indirectly through a related entity, while retaining RIC status for the amounts of income that do qualify. These rules also provide a limit on the extent to which a RIC that is commonly owned with a taxable corporation might extract business income from the corporation in the form of interest or other deductible payments, or by causing the corporation to bear expenses of the RIC's operations.

[1502] Secs. 851 and 852.

[1503] Sec. 852(a) and (b). More stringent distribution requirements must be met in order to avoid an excise tax under section 4982.

[1504] A RIC that has net capital gain either can distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 852(b)(3)(D).

[1505] Sec. 269B. These stapled stock restrictions also generally apply to real estate investment trusts.

Real estate investment trusts[1506]

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but that qualifies and elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[1507] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[1508]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT. As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[1509] Although a REIT is not required to distribute more than the 90 percent of its income described above in order to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed. Section 4981 also imposes an additional four-percent excise tax to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period.

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate related income. Such income including, for example, rents from real property, income from the sale or exchange of real property (including interests in real property)[1510] that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[1511] Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts

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[1506] For a more detailed description of REITs see description in part I.J.

[1507] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[1508] Secs. 856 and 857.

[1509] A REIT that has net capital gain either can distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[1510] The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests. Sec. 856(c)(5)(C).

[1511] Secs. 856(c)(3) and 1221(a)(1).

of personal property, are not qualifying rents.[1512] In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income. An exception applies for certain rents received from taxable REIT subsidiaries (described further below).

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income.[1513]

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items, and Government securities.[1514] Real estate assets generally include real property (including interests in real property and mortgages on real property) and shares in other REITs.[1515] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[1516]

Except with respect to a taxable REIT subsidiary (described further below), not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[1517] The asset tests must be met as of the close of each quarter of a REIT's taxable year.

A REIT generally cannot own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility. However, a TRS is permitted to rent qualified hotel, motel, or other transient lodging facilities,

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[1512] Sec. 856(d). Amounts attributable to the provision of certain services by an independent contractor or by a taxable REIT subsidiary can be qualified rents. Sec. 856(d)(7).

[1513] Sec. 856(c)(3).

[1514] The term "Government security" is defined by reference to the Investment Company Act of 1940, and means "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit in any of the foregoing." 15 U.S.C. sec. 80a-2(a)(16). The same definition applies for certain RIC purposes.

[1515] Sec. 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[1516] Sec. 856(c)(4)(B)(i).

[1517] Sec. 856(c)(4)(B)(iii).

or qualified health care facilities, from its parent REIT and is permitted to hire an independent contractor to operate such facilities.[1518] Transactions between a TRS and a REIT are subject to a number of specified rules, including a 100-percent excise tax to the extent certain transactions do not meet arm's length standards.

REITs are subject to restrictions on "stapled" stock similar to those described above for RICs.[1519]

Real estate mortgage investment conduits[1520]

A real estate mortgage investment conduit ("REMIC") is an entity used for securitizing mortgages on real estate.[1521] A REMIC is not subject to tax at the entity level (except for a 100-percent excise tax on prohibited transactions, which include the receipt of compensation for services or other nonpermitted income).[1522] Income or loss of the REMIC is taken into account by the holders of residual interests in the REMIC. REMICs are subject to restrictions on organizational structure, income, assets, and permitted transactions.

Cooperatives

There are several types of cooperatives, including tax-exempt farmers' cooperatives and other corporations operating on a cooperative basis.[1523] In determining its taxable income, a cooperative does not take into account the amount of patronage dividends paid to patrons of the cooperative. The cooperative deducts other distributions, including dividends paid on capital stock and amounts distributed on a patronage basis to patrons during the taxable year. Patrons of the cooperative include in their income the amount of patronage dividends and other distributions made on a patronage basis. Thus, these amounts are subject to tax in the hands of the patrons, but not in the hands of the cooperative. To this extent, a cooperative is treated as a passthrough entity.

A cooperative can be a publicly traded entity; however, only patrons are entitled to the benefits of the passthrough treatment through the dividends paid deduction. To the extent the earnings of the cooperative are allocated or distributed to public shareholders that are not dealing with the cooperative patrons, the cooperative is subject to corporate level tax.

[1518] Sec. 856(d)(8)(B).

[1519] See section 269B.

[1520] For a more detailed description of REITs see description in part I.J.

[1521] Sec. 860A.

[1522] Sec. 860F.

[1523] See, *e.g.,* sec. 521.

Check-the-Box Regulations

On April 3, 1995, the Service announced in Notice 95-14[1524] that it was considering promulgating regulations that would allow taxpayers to treat domestic unincorporated business entities as partnerships or, alternatively, associations taxable as corporations on an elective basis. The Service also stated that it was considering the possible extension of such treatment to foreign business organizations. Proposed regulations implementing these changes were issued by the Treasury Department on May 13, 1996,[1525] and were adopted without fundamental changes as final regulations on December 17, 1996.[1526] The final regulations generally are effective January 1, 1997.

The major change made by the check-the-box regulations is to allow tax classification as either a partnership or a corporation to be explicitly elective, subject to minimal restrictions (compared to the prior entity classification regulations),[1527] for any domestic nonpublicly traded unincorporated entity with two or more members. In addition, the check-the-box regulations explicitly provide that a single-member unincorporated entity may be treated as a corporation or may be disregarded (treated as not separate from its owners). A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation. The check-the-box regulations also differ from the previous regulations in treating certain entities as per se corporations for tax purposes.

The check-the-box regulations retain the rules of the previous regulations for distinguishing "business entities" from trusts. Under the check-the-box regulations, certain business entities will be classified automatically as per se corporations.[1528] These generally are domestic entities formed under a State corporation statute that describes the entity as a corporation, joint-stock company, or in similar terms. They also include insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State or a foreign government,[1529] and organizations that are taxable as corporations under other Code provisions, such as the provisions for publicly traded partnerships.[1530]

[1524] 1995-1 C.B. 297.

[1525] 1996-1 C.B. 865.

[1526] T.D. 8697.

[1527] For domestic LLCs organized in States on whose LLC statutes the Service issued revenue rulings, classification as a partnership was generally attainable if the taxpayer so desired, even prior to the check-the-box regulations.

[1528] Under the check-the-box regulations, whether an arrangement is an "entity" for purposes of the check-the-box regime is determined under Federal, not local, law.

[1529] T.D. 9012, amending Treas. Reg. sec. 301.7701-2(b)(6) to include any business entity wholly owned by a foreign government.

[1530] Sec. 7704.

Similarly, the check-the-box regulations classify as per se corporations certain foreign business entities that are listed in the regulations, including, for example, a U.K. Public Limited Company.[1531] In broad terms, the foreign entities listed in the regulations are corporations that generally are not closely held and the shares of which can be traded on a securities exchange.

A domestic or foreign entity that is not classified as a per se corporation under the above rules is a so-called "eligible" entity that may elect how it will be classified under the regulations' check-the box regime. An eligible entity with two or more members may elect to be classified as a corporation or a partnership. An eligible entity with a single member may elect to be classified as a corporation or to be disregarded (treated as not separate from its owner). If the single owner of a business entity that elects to be disregarded is a bank (as defined in sec. 581), then the special rules applicable to banks continue to apply as if the wholly-owned entity were a separate entity.

For eligible entities that fail to make an election, the check-the-box regulations include certain default rules. Under the default rules, a domestic entity that has multiple members is classified as a partnership. In the case of a domestic single-member entity, the default classification is as a disregarded entity not separate from its owner. In the case of foreign entities with multiple members, the default classification is as a partnership if at least one member does not have limited liability, and as a corporation if all members have limited liability. Default classification for a single-member foreign entity is as a corporation if the single owner has limited liability, and as a disregarded entity if the owner does not have limited liability.

The check-the-box regulations were intended to relieve both taxpayers and the IRS from the need to expend resources determining the proper classification of unincorporated entities, when classification was effectively elective for well-advised taxpayers. The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. Nevertheless, Treasury and the IRS recognized that such increased flexibility in entity classification in the foreign context could provide greater opportunities than under existing regulations for inconsistent, or hybrid, entity classification in the international context.[1532]

[1531] An entity is treated as domestic if it is created or organized under the law of the United States or of any State; an entity is treated as a foreign entity if it is not domestic under this definition.

[1532] Notice 98-11 addresses the use of "hybrid branches" to circumvent the purposes of subpart F. Shortly after the publication of Notice 98-11, the IRS issued temporary and proposed regulations addressing the transactions described in the Notice. Prior to the regulations taking effect, the IRS issued Notice 98-35, which withdrew Notice 98-11, and announced its intention to withdraw the temporary and proposed regulations. See Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 48-49.

3. Federal income tax rate structure

Individual Tax Rates

In general

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of up to $8,925 for single filers and up to $17,850 for married taxpayers filing joint returns or surviving spouses) to 39.6 percent (for taxable income over $400,000 for single filers and $450,000 for married taxpayers filing joint returns) for taxable year 2013; the intermediate rates are 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent.[1533] The maximum tax rate on net long-term capital gains generally is 20 percent.[1534] Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains.[1535]

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.[1536] The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the statute.[1537] Thus, generally the maximum tax rate for an individual on its domestic production activities income is effectively 36 percent.[1538]

Tax on net investment income

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust.[1539] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.[1540] The threshold amount is $250,000 in the case of a joint return or

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[1533] Secs. 1(a), (c) and (i).

[1534] Sec. 1(h). Net gain from the sale of collectibles is taxed at a maximum 28 percent rate, while certain gain from the sale or exchange of depreciable real estate ("unrecaptured section 1250 property") is taxed at a maximum 25 percent rate.

[1535] Sec. 1(h)(11).

[1536] Sec. 199.

[1537] However, for taxpayers that have qualified income related to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (collectively, "oil related production activities income"), the deduction is limited to six percent of its oil related production activities income. Sec. 199(d)(9).

[1538] Because of the nine-percent deduction, the taxpayer is taxed at a rate of 39.6 percent on only 91 percent of income, resulting in an effective Federal income tax rate of 36 percent.

[1539] Sec. 1411.

[1540] For purposes of the tax on net investment income, modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the

surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.[1541]

C Corporation Tax Rates

In general

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000); the intermediate rates are 25 percent (for taxable income above $50,000 but not exceeding $75,000) and 34 percent (for taxable income above $75,000 but not exceeding $10,000,000).[1542] The benefit of graduated rates below 34 percent is phased out for C corporations with taxable income between $100,000 and $335,000, and the benefit of the 34 percent rate is phased out for C corporations with taxable income in excess of $15,000,000. C corporation long-term capital gains are taxed at the same rates as C corporation ordinary income. Thus, the maximum tax rate for C corporation net long-term capital gains is 35 percent.

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.[1543] The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the statute.[1544] Thus, generally the maximum tax rate for a C corporation on its domestic production activities income is effectively 31.85 percent.[1545]

Special rules

Accumulated earnings and personal holding company taxes

Taxes at a statutory rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding

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deductions and exclusions disallowed with respect to the foreign earned income). The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

[1541] For a more detailed description of the tax on net investment income, see Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2012* (JCX-18-12), February 24, 2012, pp. 7-8.

[1542] Sec. 11.

[1543] Sec. 199.

[1544] However, for taxpayers that have qualified income related to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (collectively, "oil related production activities income"), the deduction is limited to six percent of its oil related production activities income. Sec. 199(d)(9).

[1545] Because of the nine-percent deduction, the C-corporation taxpayer is taxed at a rate of 35 percent on only 91 percent of income, resulting in an effective Federal income tax rate of 31.85 percent.

company income of a corporation.[1546] The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs.[1547] The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder level tax in addition to the corporate level tax on accumulated earnings or undistributed personal holding company income.

Other rules

A number of other provisions address situations in which individuals have an incentive to direct income to corporations, or where there is an incentive to direct or divide business activity or income among a number of separate corporations, to take advantage of lower corporate graduated rates. Certain related corporations are treated as one for purposes of the graduated corporate rates.[1548] Also, certain personal service corporations are not entitled to use the graduated corporate rates below the 35-percent rate.[1549] Such a corporation is one in which substantially all the activities involve the performance of services in certain fields,[1550] and substantially all the stock of which is held directly or indirectly by employees performing services for such corporation, retirees, or certain estates or heirs of such persons. A separate provision allows the Secretary of the Treasury to reallocate income, deductions, and other items between a differently defined personal service corporation and its owners, to prevent the avoidance of Federal income tax.[1551]

[1546] Sec. 531.

[1547] Sec. 533.

[1548] Sec. 1561.

[1549] Sec. 11(b)(2) and sec. 448(d)(2). However, such corporations also are entitled to use the cash method of accounting.

[1550] Sec. 448(d)(2). Such fields are health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

[1551] Sec. 269A. A personal service corporation for this purpose is a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners (persons who own, or by attribution are deemed to own, more than 10 percent of the stock of the corporation). If substantially all the services of a personal service corporation are performed for or on behalf of one other entity, and the principal purpose of forming or availing of such personal service corporation is the avoidance or evasion of Federal income tax, the Secretary may reallocate items of income or deduction. The provision is in addition to the general provision of section 482 that permits reallocation of income, deductions, or other items among related parties. See also sec. 1551.

Alternative Minimum Tax

In general

Present law imposes a minimum tax on individuals and corporations to the extent their tentative minimum tax exceeds their regular tax liability.[1552]

Individuals

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. 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 taxpayer's taxable income increased by the taxpayer's tax preferences 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.

The exemption amounts are: (1) $78,750 ($80,800 in taxable years beginning in 2013) in the case of married individuals filing a joint return and surviving spouses; (2) $50,600 ($51,900 in taxable years beginning in 2013) in the case of other unmarried individuals; (3) $39,375 ($40,400 in taxable years beginning in 2013) in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust.[1553] These amounts are indexed for inflation. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 ($153,900 in taxable years beginning in 2013) in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 ($115,400 in taxable years beginning in 2013) in the case of other unmarried individuals, and (3) $75,000 ($76,950 in taxable years beginning in 2013) in the case of married individuals filing separate returns or an estate or a trust.

Personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI. Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock.

[1552] Sec. 55.

[1553] Rev. Proc. 2013-15, 2013-5 I.R.B. 44.

C corporations

A corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability.[1554] The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[1555] Certain credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years to the extent the regular tax exceeds the tentative minimum tax. Small corporations meeting a gross receipts test are exempt from the corporate alternative minimum tax. Generally, a corporation meets the gross receipts test if its average annual gross receipts for the prior three taxable years does not exceed $7.5 million.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences 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. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceed its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

4. Social insurance taxes

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[1556] A similar tax is imposed on the net earnings from self-employment of an individual (including a partner in a partnership) under the Self-Employment Contributions Act ("SECA").[1557]

[1554] Sec. 55.

[1555] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

[1556] See chapter 21 of the Code, secs. 3101-3128.

[1557] See chapter 2 of the Code, secs. 1401-1403.

FICA tax

In general

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee. The amount of wages subject to this component is capped at $113,700 for 2013.

Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. For wages received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages in excess of a specific threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarried individual or head of household).

The wages of individuals, including owners, employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax. The employee portion of the FICA tax generally must be withheld from wages by the employer and remitted to the Federal government with the employer's portion.

S corporation shareholders

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to FICA tax on amounts that are not wages (such as distributions to shareholders).[1558] Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wages.[1559] A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[1560]

In cases addressing whether payments to an S corporation shareholder-employee were wages for services or were corporate distributions, courts have recharacterized a portion of

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[1558] Although not applicable for FICA tax purposes, present law provides that an S corporation is treated as a partnership and a two-percent shareholder is treated as a partner, for purposes of applying income tax rules relating to employee fringe benefits. Sec. 1372.

[1559] The IRS has taken this position in Rev. Rul. 74-44, 1974-1 C.B. 287.

[1560] See*, e.g.*, *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

corporate distributions as wages if the shareholder performing services did not include a sufficient amount as wages.[1561] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[1562] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[1563] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[1564]

SECA Tax

In general

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $113,700 for 2013, reduced by wages subject to OASDI. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped. For taxable years beginning after December 31, 2012, the HI component of SECA tax is increased by 0.9 percent for self-employment income above a specific threshold, similar to the increase in the tax on the HI component for employees.

The amount subject to SECA tax is the net earnings from self-employment.[1565] This equals the gross income derived by an individual from any trade or business carried on by the

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[1561] *Herbert v. Commissioner*, T.C. Summ. Op. 2012-124 (December 26, 2012); *David E. Watson, P.C., v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *cert. denied*, 81 U.S.L.W. 3167 (U.S. 2012); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, *Joseph M. Grey Public Accountant, P.C., v. Commissioner*, 119 T.C. 121 (2002), aff'd., 93 Fed. Appx. 473 (3d Cir. 2004), and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[1562] See, *e.g.*, *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

[1563] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[1564] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 at 1019-1021 (9th Cir. 2004), the Ninth Circuit court noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). The Ninth Circuit court stated that "our approach deems none of these factors to be decisive or controlling." *Ibid*. at 1019.

[1565] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and

individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

Partners

For an individual who is a partner in a partnership, net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership.[1566] This rule applies to individuals who are general partners. The general SECA exclusions described above for specified types of income or loss apply to a partner, as well as an exclusion for certain retirement payments from the partnership if the partner rendered no services for the partnership and certain other requirements are met.

A special rule applies for limited partners of a partnership.[1567] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services. This special rule reflects State law at the time it was enacted in 1977, under which limited partners ordinarily were not permitted to participate in management of the partnership's activities without losing their limited liability protection.[1568] In recent years, State law has been changing, with the result that individuals who are limited partners under applicable State law may participate in the management and operations of the partnership without jeopardizing their

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SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[1566] There is uncertainty under present law regarding the SECA tax treatment of LLC members. Some LLC owners may take the position that they owe little, if any SECA tax by analogy to the statutory language governing limited partners, or by structuring their business to interpose an S corporation, distributions from which they argue do not constitute labor income. See Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* (JCX-48-08), June 4, 2008, pp. 60-72, for a more detailed description of the issues related to labor income and capital income under the social insurance tax.

[1567] Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law.

[1568] Social Security Amendments of 1977, Pub. L. No. 95-216. The exclusion of limited partners from the self-employment tax (except with respect to guaranteed payments for services) reflects the perception at that time that the value of accruing benefits under the Social Security system outweighed the tax cost, and that limited partnerships were used for investment rather than for service businesses. See Patricia E. Dilley, "Breaking the Glass Slipper - Reflections on the Self-Employment Tax," *Tax Lawyer*, vol. 54, Fall 2000, p.85 at note 91.

limited liability.[1569] This change in the State law rules for limited partners parallels the expansion of limited liability companies.

[1569] See, *e.g.*, Revised Uniform Limited Partnership Act (2001), sec. 303, providing, "[a]n obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership." In *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011), for example, the Tax Court held that the partners' distributive shares "arising from the legal services they performed in their capacity as partners in the law firm are subject to self-employment taxes." *Ibid.* at 151. The partnership was an LLP. The opinion discussed the meaning of the term limited partner (which is not defined in section 1402(a)(13)) and stated that "legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (*i.e.*, acting in the manner of self-employed persons), from liability for self-employment taxes." *Ibid.* at 150.

II. SUMMARIES OF SELECTED TAX REFORM PROPOSALS

A. Introduction

Over the past several years, members of Congress, commissions, and others have presented to policy makers a number of proposals to reform the Federal tax system. At the direction of Chairman Camp and Ranking Member Levin, the Joint Committee staff briefly summarizes one dozen selected proposals. The majority of the proposals reviewed retain income from all sources as the primary tax base for the taxation of both individuals and businesses. Other proposals are more accurately characterized as consumption-based taxes. To organize the summaries, the Joint Committee staff proceeds from income-based proposals to consumption-based proposals. The proposals summarized are:

1. The National Commission on Fiscal Responsibility and Reform 2010 Proposal;

2. The President's Advisory Panel on Federal Tax Reform (2005);

3. A proposal of the Debt Reduction Task Force of the Bipartisan Policy Center;

4. The President's Economic Recovery Advisory Board (2010);

5. A proposal of the Economic Policy Institute;

6. A proposal of the Center for American Progress;

7. The Budget for a Millennial America prepared by the Roosevelt Institute Campus Network;

8. The Bipartisan Tax Fairness and Simplification Act of 2011, introduced by Senators Wyden, Coats, and Begich;

9. The Tax Reduction and Reform Act of 2007, introduced by Representative Rangel;

10. A proposal of the Heritage Foundation;

11. A proposal by authors affiliated with the American Enterprise Institute; and,

12. The Fair Tax Act of 2013, introduced by Representative Woodall, *et al*.

For comparison, Part I of this document provides a comparable overview of the Federal tax system as in effect for 2013.

B. National Commission on Fiscal Responsibility and Reform 2010 Proposal

Overview

President Barack Obama established the National Commission on Fiscal Responsibility and Reform ("Commission") "to balance the budget, excluding interest payments on the debt, by 2015" and to "propose recommendations that meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending and the gap between the projected revenues and expenditures of the Federal Government."[1570] The Commission, co-chaired by Democrat former Clinton White House Chief of Staff Erskine Bowles and Republican former Senator Alan Simpson of Wyoming, issued a report on December 1, 2010 that included as a component of its plan a comprehensive tax reform proposal ("Bowles-Simpson proposal").[1571] The report outlines an illustrative tax plan that reduces marginal income tax rates, broadens the tax base, simplifies the individual income tax, and reduces the deficit by reducing tax expenditures. The Bowles-Simpson proposal also reforms the corporate income tax and places a cap on Federal revenue as a percentage of gross domestic product ("GDP").

Components

1. Individual income tax

Under prior law,[1572] the tax rates and other provisions enacted in the Economic Growth and tax Relief Reconciliation Act of 2001 ("EGTRRA")[1573] and the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA")[1574] were scheduled to expire for taxable years beginning after 2012. EGTRRA and JGTRRA generally reduced tax rates and increased many deductions and tax credits, including the earned income tax credit ("EITC") and the child tax credit. The Bowles-Simpson proposal, which was effective for years beginning after 2012 (when

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[1570] National Commission on Fiscal Responsibility and Reform, Executive Order 13531, February 18, 2010, available at http://www.whitehouse.gov/the-press-office/executive-order-national-commission-fiscal-responsibility-and-reform.

[1571] National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010, available at http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf. The chairmen subsequently established the nonprofit Moment of Truth project. The project released a subsequent proposal, not described herein. Moment of Truth Project, *A Bipartisan Path Forward to Securing America's Future*, April 2013, available at http://www.momentoftruthproject.org/sites/default/files/Full%20Plan%20of%20Securing%20America%27s%20Future.pdf.

[1572] The Commission reported the Bowles-Simpson proposal on December 1, 2010, before the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312), or the American Taxpayer Relief Act of 2012 (Pub. L. No. 112-240), which extended various expiring tax provisions. The term "prior law" refers to the tax laws as in effect on December 1, 2010.

[1573] Pub. L. No. 107-16.

[1574] Pub. L. No. 108-27.

these provisions would have expired), keeps the EITC and the child tax credit at their pre-EGTRRA levels of between $457 and $5,666 for the EITC and $1,000 per child for the child tax credit. It also retains the prior law standard deduction and personal exemption levels.

This proposal eliminates all itemized deductions, but allows a 12-percent nonrefundable tax credit for mortgage interest expenses attributable to $500,000 of mortgage principal and for charitable donations above two percent of adjusted gross income ("AGI"). After the mortgage interest deduction, deductions for State and local taxes make up the largest category of deduction eliminated for individual taxpayers. Interest payments on State and local and private activity bonds that currently are tax-exempt become taxable for bonds issued after December 31, 2012.

The proposal also caps the exclusion for employer provided health insurance at the 75th percentile of premiums beginning in 2014 and through 2018, then reduces the cap each year beginning in 2019, such that the exclusion is totally phased out by 2038.

The statutory rates that apply to ordinary income beginning in 2013 are structured in three brackets and reduced. Table 25 provides a summary of individual ordinary income tax rates by 2013 income brackets for married taxpayers filing joint returns under prior law and under the proposal. Both dividends and capital gains are taxed at ordinary income tax rates.

Table 25.−Statutory Tax Rates Under Prior Law and Proposal

2013 Income Brackets for Joint Filers (estimated)	Statutory Tax Rates (prior law)	Statutory Tax Rates (proposal)
<$17,500	15	12
$17,501-$59,300	15	12
$59,301-$143,350	28	22
$143,351-$218,450	31	22
$218,451-$390,050	36	28
>$390,050	39.6	28

The Bowles-Simpson proposal consolidates the multiple types of tax-preferred retirement accounts and limits contributions to the lesser of $20,000 or 20 percent of income. It makes no changes to the tax treatment of employer-provided defined benefit pension plans. It expands the saver's credit.

The proposal eliminates most other individual income tax preferences.

Finally, the proposal permanently repeals the alternative minimum tax.

2. Corporate income tax (and business-related provisions for pass-through entities)

Under present and prior law, certain corporations are taxed under subchapter C of the Code ("C corporations") at a top statutory rate of 35 percent for C corporations with taxable income over $10,000,000. C corporations with taxable income less than $50,000 are taxed at a rate of 15 percent; corporations with taxable income from $50,001-$75,000 are taxed at a rate of 25 percent, and C corporations with taxable income from $75,001 to $10,000,000 are taxed at a rate of 34 percent. Under the proposal, all C corporations are taxed at a rate of 28 percent. Income of other business forms, including corporations taxed under subchapter S of the Code ("S corporations"), partnerships, and sole proprietorships, is taxed through the individual income tax Code; thus the changes to statutory tax rates for the individual income tax under this proposal also apply to the taxation of the business income of these passthrough entities.

Both the individual and corporate income taxes include many different deductions, credits, and other special treatment of certain types of income and expenses of businesses. The Bowles-Simpson proposal calls for eliminating many of them. Specifically, the proposal eliminates the following business provisions: the modified accelerated cost recovery system ("MACRS") for depreciation; the last-in, first-out ("LIFO") method of accounting for inventory; the domestic production deduction for qualified production activities income, and the low-income housing tax credit.

The Bowles-Simpson proposal also calls for a movement to a territorial tax system for active foreign-source income. However, the proposal provides no details with respect to this aspect of business income taxation. The proposal maintains present law for the taxation of passive foreign-source income.

3. Payroll taxes

While many tax expenditures are eliminated from the individual income tax, the Bowles-Simpson proposal makes no changes to the base of the payroll tax as a result of provisions under the income tax. However, the Bowles-Simpson proposal gradually increases the cap on wages subject to the social security payroll tax so that the tax covers 90 percent of national wages by 2050. The proposal also allows the cap on wages to increase in years when there is no cost of living adjustment ("COLA") for benefits. In addition, the payroll tax system is expanded to cover newly hired State and local workers after 2020.

4. Estate and gift taxes

The Commission makes no recommendation regarding estate and gift taxes.

5. Excise taxes

The Commission recommends gradually increasing the per-gallon motor fuels taxes by 15 cents between 2013 and 2015.

The rate of the excise tax on high cost employer-provided health coverage is reduced from 40 percent to 12 percent.

6. Other

The proposal changes the basis of indexing parameters of the tax Code from reliance on the consumer price index for urban consumers ("CPI-U") to the chain-weighted consumer price index ("chained-CPI").

Some of the revenue raised by eliminating tax expenditures is used to reduce the deficit.

The proposal caps revenue at 21 percent of GDP. However, the proposal provides no details with respect to the mechanism by which the cap is implemented.

C. The President's Advisory Panel on Federal Tax Reform (2005)

Overview

President George W. Bush formed the President's Advisory Panel on Federal Tax Reform in January, 2005, to identify the major problems in the tax code and to recommend options to make the code simpler, fairer, and more conducive to economic growth on a revenue neutral basis. The Chairman and Vice-Chairman of the Panel were former Republican Senator Connie Mack, III, and former Democratic Senator John Breaux. The Panel reached consensus to recommend two tax reform plans, the Simplified Income Tax Plan and the Growth and Investment Tax Plan, both described in its November, 2005, report.[1575] The two plans differ in the taxation of business and capital income. In addition, the Panel considered but did not ultimately recommend a progressive consumption tax plan, a value-added tax, and a national retail sales tax, which are given mention in the report.

1. Components of the Simplified Income Tax Plan

a. Individual income tax

This plan provides four tax rate brackets for individuals: 15, 25, 30, and 33 percent. The plan makes the tax brackets and other tax provisions for married couples equal to twice the amount for unmarried taxpayers to reduce marriage penalties.

Table 26.−Statutory Tax Rates under the Simplified Income Tax Plan

Individual Income Tax Rates under the Simplified Income Tax Plan	
Income Bracket for Joint Filers	**Tax Rate**
up to $78,000	15 %
$78,001 - $150,000	25 %
$150,000 - $200,000	30 %
$200,001 or more	33 %

Under the plan, the alternative minimum tax is repealed.

[1575] *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform,* November 2005, available at http://www.taxpolicycenter.org/taxtopics/upload/tax-panel-2.pdf.

The plan consolidates family, child, and work-related tax benefits into two credits. The Family Credit ranges from $1,150 to $3,300 depending on filing status, with an additional $1,500 credit for each child and a $500 credit for each other dependent. The Work Credit (replacing the present-law earned income credit), in an amount up to $5,800 for a family with two or more children, phases out at higher income levels. The plan substitutes for the mortgage interest deduction a Home Credit equal to 15 percent of mortgage interest paid, limited in a manner related to the taxpayer's regional average housing prices. A deduction is allowed for charitable contributions subject to a floor of one percent of income. Education tax benefits are rolled into the Family Credit and the Save for Family tax-preferred account (described below). Tax deductions for State and local taxes are repealed. Individual taxpayers may purchase health insurance in the individual market with pre-tax dollars up to the amount of an average premium, and the present-law exclusion for employer-provided health insurance is limited to the amount of an average premium. Tax-free treatment of employer-provided fringe benefits (other than in-kind benefits) is eliminated.

Addressing savings of individuals, the plan replaces defined contribution (and similar employer-sponsored) plans with Save at Work accounts using the present-law 401(k) plan contribution limits. Defined benefit plans, however, are retained. Other retirement savings plans (IRAs) are replaced by a Save for Retirement account available to all individual taxpayers with a $10,000 annual limit that is indexed for inflation. A Save for Family account with a $10,000 annual limit is provided with withdrawals for education, medical, and new home costs, replacing present-law tax-favored arrangements. Roth-style tax treatment applies to these two accounts, in that contributions are made on an after-tax basis and distributions are excludable. A refundable Saver's Credit is available for low-income taxpayers. Social security benefits are excludable for married taxpayers with less than $44,000 of income (indexed for inflation) ($22,000 for single taxpayers), and up to 85-percent includable in income above these thresholds.

Dividends received by individuals from U.S. earnings of U.S. corporations are fully excludable from income. Capital gains of individuals from sales or exchanges of stock of U.S. companies are 75-percent excludable, resulting in a tax rate from 3.75 to 8.25 percent depending on the applicable individual rate bracket. Interest income is fully includable at regular income tax rates.

b. Corporate and other business income tax

Small businesses with an average over the preceding three years of less than $1 million in annual gross receipts are taxed at individual rates, with a top rate of 33 percent. Small businesses may use a simplified method of cash-basis accounting and are allowed immediate expensing for all assets (other than land and buildings which retain present-law treatment), for simplification. The report recommends generally that tax rules for passthrough entities be made more uniform to simplify choice of entity considerations.

A medium-sized business with receipts greater than $1 million but less than $10 million also uses a simplified cash method of accounting but depreciates rather than expenses the purchase of assets under a simplified depreciation system, and is required to maintain inventories if in an inventory-intensive industry. The simplified depreciation system provides for four categories of depreciable assets. Depreciation is computed by multiplying the taxpayer's

average balance in each asset category by the depreciation rate for that category. The four depreciation rates are 30, 7.5, 4, and 3 percent.

A large business with gross receipts of $10 million or greater is subject to tax at a single 31.5 percent rate. In lieu of expensing, the simplified depreciation system applies. A large business is required to maintain inventories. A territorial international tax system applies in lieu of the present-law worldwide tax system.

The corporate alternative minimum tax is repealed. Over 40 special business provisions are eliminated. The double tax on corporate profits is largely eliminated by the excludability of dividend income.

c. Payroll taxes

The plan makes no recommendation with respect to payroll taxes.

d. Estate and gift taxes

The plan makes no recommendation with respect to estate and gift taxes.

e. Excise taxes

The plan makes no recommendation with respect to excise taxes.

2. Components of the Growth and Investment Tax Plan

a. Individual income tax

For individuals, this plan is generally similar to the Simplified Income Tax Plan above, so the rate brackets for married taxpayers are twice those for unmarried taxpayers. However, the Growth and Investment Tax Plan provides for three tax rate brackets: 15, 25, and 30 percent. Further, dividends received, capital gains, and interest income held outside the tax-free accounts provided under the plan are each taxed at a 15-percent rate. Under this plan, the Save at Work accounts have Roth-style tax treatment, so that contributions are made on an after-tax basis and distributions are excludable.

Table 27.−Statutory Tax Rates Under the Growth and Investment Tax Plan

Individual Income Tax Rates under the Growth and Investment Tax Plan	
Income Bracket for Joint Filers	**Tax Rate**
up to $80,000	15 %
$80,001 - $140,000	25 %
$140,001 or more	30 %

b. Corporate and other business income tax

This plan applies a business cash-flow tax at a flat 30-percent rate to all businesses other than sole proprietorships. The net positive cash flow is taxed at this business rate, regardless of the type of business entity, discarding present-law tax accounting rules.

All business investments are expensed (rather than depreciated).

Interest paid is not deductible and interest received is not includible under this plan (except under special rules for financial intermediaries), on the theory that allowing expensing and an interest deduction would give a net tax subsidy to new investment. Financial services firms such as banks treat all principal and interest inflows as taxable and deduct all principal and interest outflows. A corresponding deduction against the cash flow tax is allowed to businesses purchasing financial services (*e.g.*, borrowers) applying a proxy interest rate and requiring rules to distinguish financial from nonfinancial businesses.

Business tax losses are not refundable, but are carried forward with interest.

International business transactions are subject to a destination-basis tax with border adjustments.

The report notes that this income tax plan is generally equivalent to a subtraction method VAT at a 30 percent rate, coupled with a progressive system of wage subsidies and a separate single-rate tax on capital income.

c. Payroll taxes

The plan makes no recommendation with respect to payroll taxes.

d. Estate and gift taxes

The plan makes no recommendation with respect to estate and gift taxes.

e. Excise taxes

The plan makes no recommendation with respect to excise taxes.

D. A Proposal of the Debt Reduction Task Force of the Bipartisan Policy Center

This proposal was submitted by the Debt Reduction Task Force of the Bipartisan Policy Center, chaired by Senator Peter Domenici and Dr. Alice Rivlin, in November, 2010, to address immediate needs for economic growth and to control Federal government debt in the long term. [1576] Subsequent updates to the plan (referred to as Domenic-Rivlin Debt Reduction Task Force Plan 2.0) have since been made. [1577]

By 2022, the plan proposes to reduce spending to 22.1 percent of GDP, raise revenue of 20.7 of GDP, reduce the deficit to 1.4 percent of GDP, and to reduce the national debt to 69 percent of GDP. The plan achieves this goal through a combination of domestic discretionary and defense spending cuts and through changes to the tax system to broaden the base, lower rates, and raise more revenue. This summary focuses on the tax-related aspects of the proposal, as updated.

Components

1. Individual income tax

The plan eliminates most deductions and credits and simplifies many that remain.[1578] It reduces the rate structure to two rates, 15 percent and 28 percent. The 15 percent rate generally begins at the first dollar of income, because the standard deduction and personal exemptions are eliminated. The 28 percent rate begins at approximately $51,000 for single filers and $102,000 for couples.

Table 28.−Federal Individual Income Tax Rates for Married Joint Filers Under Proposal

If taxable income is:	Then income tax equals:
Not over $102,000	15% of the taxable income
Over $102,000	$15,300 plus 28% of the excess over $102,000

Other principal features of the plan include:

[1576] The original proposal may be found on the Bipartisan Policy Center Website at: http://bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf ,

[1577] The updated proposal may be found on the Bipartisan Policy Center Website at: http://bipartisanpolicy.org/sites/default/files/D-R%20Plan%202.0%20FINAL.pdf

[1578] See Appendix B of the plan for a complete list of tax expenditures that are retained in the plan.

- An immediate, large income tax rebate similar to those in 2001 and 2008, of revenue magnitude similar to that of the payroll tax reduction that expired in 2012

- Elimination of the alternative minimum tax.

- Taxation of capital gains and dividends at ordinary rates, excluding the first $1,000 ($500 for singles and head of household filers) of capital gains (or losses). The exclusion for interest on public purpose state and local bonds is retained.

- Elimination of all deductions other than casualty losses, miscellaneous itemized deductions in excess of five percent of AGI, and medical expenses in excess of 10 percent of AGI. A 20 percent refundable credit is provided for charitable contributions, and, for up to $25,000 per year, mortgage interest on a primary residence. These two credits will phase down to 15 percent over 5 years. A 15 percent refundable credit (or a deduction for 28 percent bracket taxpayers) is provided for retirement savings up to 20 percent of earnings or $20,000.

- Conversion of the earned income credit to a 17.5 percent refundable credit on the first $20,000 of earnings, and the child credit is converted to a $1,600 per child refundable credit. The child and dependent care credit is retained in its current form.

- The exclusion of social security income is replaced with a non-refundable credit for social security beneficiaries equal to 15 percent of the present-law standard deduction, and a non-refundable credit is created equal to 15 percent of social security benefits.

- Replacement of the high premium excise tax on employer-based health insurance with a cap in 2015 on the amount of employer based health insurance that may be excluded from income, and reduces that cap ratably over ten years until all health insurance is included.

2. Corporate income tax

The plan sets the top corporate rate at 28 percent instead of the current 35 percent. No mention is made whether the current law corporate rates lower than 28 percent are retained, or whether all corporate income is taxed at 28 percent. The plan eliminates most corporate tax expenditures. Among the major provisions the plan retains are accelerated depreciation of machinery and equipment and buildings other than rental housing, expensing of certain small investments, expensing of research and experimentation expenditures, employer defined benefit plans, and deferral of income from controlled foreign corporations. [1579]

[1579] See Appendix B of the plan for a complete list of tax expenditures that are retained in the plan.

3. Payroll taxes

The plan raises the current cap on wages subject to the social security tax gradually, over a 38-year period, until a level covering 90 percent of national earnings is reached. At current income levels, this would be equivalent to about $180,000. After reaching the 90 percent target, the cap will be adjusted annually to maintain the 90 percent standard.

4. Estate and gift taxes

The original plan returns the estate tax to its 2009 parameters; the updated plan appears to retain present law.

5. Excise taxes

The motor fuels taxes are increased by 15 cents per gallon and indexed for inflation. Taxes on alcohol and tobacco are increased, but no details are provided. A tax of two cents per ounce is imposed on sugared beverages.

E. The President's Economic Recovery Advisory Board (2010)

Overview

The Report on Tax Reform Options, prepared by the President's Economic Recovery Advisory Board (2010) ("Board"), summarizes various options that have been previously proposed (and their advantages and disadvantages) for simplifying the Code, improving taxpayer compliance, and reforming the corporate domestic and international tax rules (the "Report").[1580] The Board was not asked to recommend a major overarching tax reform and the Report does not provide policy recommendations. The Board excluded options that raise taxes for families with incomes less than $250,000 a year.

Components

1. Individual income tax

The Report summarizes various options to simplify the Code in the areas of family credits and incentives, savings and retirement accounts, capital gains, tax filing, small businesses, and the alternative minimum tax ("AMT"). The specific options discussed in each area are provided below.

Families

The Report discusses options for simplifying the tax treatment of families. The options are: (1) consolidate the dependent exemption, the standard deduction, and the child tax credit into a family credit available to all taxpayers; (2) replace the earned income tax credit ("EITC") and refundable portion of the child tax credit with a "work credit;" (3) eliminate the dependent care benefit and replace tax benefits for higher education with a generous extended family credit for full time students under age 22; (4) replace the 18 different education tax incentives with one or two alternatives; (5) simplify the taxation of income of unearned income of dependent children (the "kiddie tax"); (6) harmonize rules for the EITC and child tax credit; and (7) eliminate the household maintenance test for filing status and the EITC.

Savings and retirement incentives

The Report discusses options for simplifying savings and retirement incentives. The options include: (1) consolidate all employer-sponsored retirement plans into one work-based retirement account, and (2) consolidate all special purpose savings accounts (*e.g*, Health Savings Accounts, section 529 plans) into one account for nonretirement savings; (3) allow all workers to contribute to either or both an IRA and an employer-sponsored plan irrespective of income and eliminate nondeductible IRAs; (4) make the saver's credit a matching contribution to a retirement account and eliminate the cliffs in the current credit rate structure; (5) expand automatic enrollment in retirement plans; (4) require automatic rollovers of separated workers

[1580] The proposal may be found on the White House website, available at http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf.

retirement accounts and limit hardship distributions before age 59½; (5) simplify rules for employers sponsoring plans; (6) eliminate required minimum distributions for individuals with retirement assets below a certain threshold; and (7) include in income a single percentage of social security benefits over a single threshold and determine modified adjusted gross income without regard to social security benefits.

Taxation of capital gains

The Report discusses options for simplifying the taxation of capital gains. The options are: (1) tax section 1250 gain and collectibles gain at ordinary tax rates or another uniform maximum rate; (2) require the use of the average cost method to determine cost basis for all mutual fund shares; (3) modify small business stock rules to allow the 100 percent exclusion for stock purchased after 2008 and a 25-percent exclusion off capital gains rates for stock purchased before 2009; (4) repeal section 1044 and section 1202 related to small business stock; (5) replace the separate rates on capital gains with a 50 percent exclusion; (6) limit or repeal the special treatment of like-kind exchanges under section 1031; (7) index for inflation the capital gain exclusion on the sale of principal residences; and (8) extend holding period for capital gains exclusion on primary residences.

Tax filing

The Report discusses options for simplifying the filing process. The options are: (1) use an IRS pre-filled return; (2) allow taxpayers to download their own third party reported tax information from the IRS; and (3) increase the standard deduction and limit itemized deductions.

Small businesses

The Report discusses options to simplify tax compliance for small businesses. The options are: (1) expand the use of simplified cash accounting such that taxable income equals cash receipts minus cash business expenses—including cash outlays for inventories, materials, and depreciable property other than buildings; (2) permit a standard home office deduction; and (3) simplify recordkeeping requirements for cell phones, personal digital assistants, and other devices.

The AMT

The Report discuss options to modify the AMT. The options are: (1) eliminate the AMT; and (2) reduce differences between the AMT and regular income tax provisions.

2. Corporate income tax

The Report discusses options to reform the corporate tax system. The options include: (1) reduce the statutory corporate tax rate; and (2) allow taxpayers to expense all or a portion of their new investment immediately.

The Report also discusses three options to broaden the corporate tax base. The options are: (1) limit the deductibility of net interest expense; (2) tax corporate and noncorporate entities similarly; and (3) eliminate or reduce corporate and other tax expenditures such as the domestic

production deduction, accelerated depreciation, special treatment for employee stock ownership plans, exemption of credit union income from tax, and the low-income housing credit. To tax corporate and noncorporate businesses similarly, the Report discusses two opposing reforms: (1) require firms with certain corporate characteristics to pay the corporate income tax; and (2) integrate the corporate and individual income tax systems.

International corporate tax

The Report discusses four options for international tax reform. The options are: (1) move to a territorial system; (2) move to a pure worldwide system without deferral and with a lower corporate tax rate; (3) limit or end deferral with the current corporate tax rate; and (4) retain the current system but lower the corporate tax rate.

3. Payroll taxes

The Report proposes clarification of the treatment of workers as employees or independent contractors by repealing the common law test, allowing the IRS to publish guidance on worker classification, and repealing special safe-harbor rules that allow businesses to treat employees as independent contractors (section 530 of the Revenue Act of 1978). The Report also proposes that all partners, LLC members, and S corporation shareholders pay self-employment taxes on their share of business income, other than those who do not materially participate in the business. Exclusions for certain types of income or loss apply.

4. Estate and gift taxes

The Report does not discuss estate and gift taxes.

5. Excise taxes

The Report does not discuss excise taxes.

6. Other

Compliance options

The Report discusses options for improving taxpayer compliance and reducing the tax gap. The options are: (1) dedicate more resources to enforcement and enhance enforcement tools; (2) increase third party information reporting and source withholding on large payments to independent contractors and business-to-business payments; (3) require small businesses that use the simplified cash accounting method to use a segregated bank account for all business receipts and expenditures and require banks to report the receipts and expenditures within the account annually; (4) increase voluntary disclosure programs; (5) provide for multiple-year audits for small businesses and individuals where there is pattern of noncompliance; (6) extend the three-year statute of limitations where there are adjustments by a State that could affect Federal liability; and (7) lower the threshold for IRS auditors to re-open earlier returns when they find noncompliance.

F. A Proposal of the Economic Policy Institute

Summary

On May 25, 2011, the Economic Policy Institute submitted a proposal[1581] (the "EPI plan") to achieve a balanced budget by 2018 and stabilize long-term debt as a share of gross domestic product. The plan includes measures to control health costs, to gradually reduce defense spending, and to collect higher levels of revenue, especially from high-income earners and corporations. This summary focuses on the tax-related aspects of the proposal. The tax provisions in the EPI plan are projected to result in $184.1 billion of additional revenue in 2015, relative to President Obama's FY2011 budget proposal.

Components

1. Individual tax

In general

The EPI plan proposes repeal of the tax cuts instituted under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") for individuals with adjusted gross income ("AGI") above $200,000 ($250,000 for joint filers), and a surcharge of 5.4 percent on AGI above $500,000 for single filers ($1 million for joint filers).

Table 29.−Proposed Income Tax Rates Under the EPI Plan

Single Filer Income	Joint Filer Income	Tax Rate
$0-8,750	$0-17,500	10%
$8,751-35,500	$17,501-71,000	15%
$35,501-86,000	$71,001-143,350	25%
$86,001-179,400	$143,351-218,450	28%
$179,401-199,350	$218,451-241,900	33%
$199,351-$390,050	$241,901-390,050	36%
$390,051-500,000	$390,051-1,000,000	39.6%
>$500,000	>$1,000,000	39.6%+5.4%surcharge

It also recommends extension of the Making Work Pay refundable tax credit, which replaces 6.2 percent of income up to a maximum of $400 for working individuals who are not claimed as dependents ($800 for joint filers), and is phased out for those with over $75,000 of AGI ($150,000 for joint filers).

[1581] "Investing in America's Economy: A Budget Blueprint for Economic Recovery and Fiscal Responsibility," as submitted to the Peter G. Peterson Foundation as part of the Solutions Initiative. This report is a joint project with Demos and the Century Foundation. The full proposal and an executive summary are available at *http://www.pgpf.org/solutionsinitiative*.

The EPI plan institutes the personal exemption phaseout and the limitation on itemized deductions for taxpayers with greater than $200,000 of AGI ($250,000 if joint filing).[1582] It also proposes capping the limit on itemized deductions at 15 percent. However, the proposal includes special treatment for charitable contributions. In particular, the plan would convert the deduction for charitable contributions to a refundable credit at a flat 25 percent rate. Similarly, the plan advocates replacing the mortgage interest deduction with a fully refundable tax credit of 15 percent of interest on up to $500,000 of mortgage debt.

Child tax credit and earned income tax credit

The EPI plan proposes replacing the means-tested, partially refundable child tax credit with a credit that is refundable regardless of income. The plan also makes permanent the expansions of the earned income tax credit enacted in the American Recovery and Reinvestment Act ("ARRA").[1583] In addition, the EPI plan increases the credit for taxpayers with no qualifying children.

Tax on capital gains and dividends

The EPI plan proposes taxing capital gains and dividends as ordinary income.

2. Corporate income tax

The EPI plan would limit the deductibility of corporate debt interest payments for financial firms by enacting an after-tax credit of 25 percent rather than allowing pre-tax expensing. The plan recommends eliminating the tax deferral on earnings from U.S.-controlled foreign subsidiary corporations.

3. Payroll taxes

The EPI plan proposes eliminating the Social Security payroll tax cap for employers and raising the cap on earnings for employees to 90 percent of earnings. The plan also proposes allowing employee contributions to salary reduction plans to be subject to the payroll tax.

4. Estate and gift taxes

The EPI plan proposes a new rate structure for the estate tax: exempt the first $2 million from tax ($4 million for married filing jointly); enact a rate structure of 45 percent on estates worth less than $10 million; 50 percent on the taxable portion of estates above $10 million; and 55 percent on the taxable portion of estates above $50 million.

[1582] The personal exemption phaseout and the limitation on itemized deductions for high income taxpayers (greater than $250,000 AGI for single filers; greater than $300,000 AGI for joint filers) were reinstated in the American Taxpayer Relief Act of 2012, subsequent to the EPI proposal.

[1583] Pub. L. No. 111-5. The American Taxpayer Relief Act of 2012 extends this provision for five years.

5. Excise taxes

The EPI plan proposes increasing Federal motor fuel excise taxes by 25 cents per gallon. The EPI plan also would institute a carbon tax based on the carbon content of the fuel source. The plan proposes elimination of special tax preferences for fossil fuel production which allow for the expensing of some oil drilling costs and provides deductions for the production of oil, natural gas, and coal.

6. Other

The EPI plan proposes a "financial crisis responsibility fee" of 0.15 percent of a financial institution's covered liabilities. This fee would apply only to financial institutions with over $50 billion in assets. The EPI plan also includes a financial transactions tax of 0.5 percent on stock transactions.

The plan also adopts Presidents Obama's FY2011 budget proposal relating to improved reporting, compliance, and enforcement.[1584] For example, these include requiring recipients of rental income to report all major expense payments, requiring certified taxpayer identification numbers for contractors, strengthening rules for the classification of employees as independent contractors, and increasing the penalty for failing to file information returns.

[1584] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 430-520.

G. A Proposal of the Center for American Progress[1585]

This proposal was submitted by the Center for American Progress in May 2011 and provides a framework for spending limits on a unified security budget and on non-security discretionary spending ("the CAP reform plan"). Within this framework, total spending would equal 23 percent of gross domestic product in 2035. The proposal also calls for raising additional revenue.

Components

1. Individual Income Tax

The CAP reform plan calls for comprehensive reform of the individual income tax which would be phased-in over a six-year period. The individual rate structure for joint returns under this plan follows:

Table 30.−Individual Rate Structure for Joint Filers

Income Over	But Not Over	Marginal Rate
$0	$100,000	15%
$100,000	$150,000	25%
$150,000	$400,000	30%
$400,000	_	39.60%

Notes: Bracket thresholds for single filers are half of those for joint filers and bracket thresholds for heads of households are halfway between those for joint filers and singles.

Some other major elements of the CAP reform plan are listed below:

- Repeal above-the-line deductions, exemptions, and unspecified loopholes;
- Eliminate the individual alternative minimum tax;
- For itemizers, replace with a 15-percent credit the deductions for mortgage interest (limited to $25,000 of interest annually), charitable contributions, and State and local taxes;

[1585] As submitted to the Petersen Foundation at http://www.americanprogress.org/wp-content/uploads/issues/2011/05/pdf/budget_for_growth.pdf.

- For non-itemizers, replace the standard deduction with an "alternative credit" ($6,200 for married couples and $3,100 for other filers (indexed for inflation));
- Expand the child credit to $1,250 (indexed for inflation);
- Extend permanently three temporary elements of the earned income tax credit: (1) the reduced earnings threshold, (2) the 45-percent rate, and (3) the higher phase-out threshold for joint filers;
- Extend permanently the research tax credit;
- Reinstate Build America Bonds (introduced in the American Recovery and Reinvestment Act of 2009) and limit tax-exempt bonds;
- Tax capital gains as ordinary income with 28-percent maximum rate;
- Tax dividends as ordinary income;
- Create a 33-percent refundable tax credit for all retirement savings, with contributions limited to $15,000 or 15 percent of adjusted gross income;
- Tax carried interest income as ordinary income;
- Repeal the foreign earned income exclusion;
- Repeal the exception from passive loss rules for $25,000 in rental losses;
- Repeal the tax expenditures for higher education other than the American opportunity tax credit;
- Repeal the dependent care credit;
- Repeal employer subsidies for child and dependent care;
- Repeal the exclusion of employer-provided parking reimbursements; and
- Repeal health savings and flexible spending accounts.

Millionaire's surtax

The CAP reform plan imposes a temporary two percent surtax on adjusted gross income of more than $1 million and less than $10 million and five percent surtax on adjusted gross income of more than $10 million beginning in 2015. This surtax is repealed when the broader individual income tax reform becomes effective in 2017.

2. Corporate income tax

The CAP reform plan calls for reform or repeal of several business tax provisions though not all business income is taxed at corporate tax rates. A specific corporate rate is not provided. Some business tax expenditures repealed under the CAP reform plan include:

- Fossil-fuel tax expenditures
  - Enhanced oil recovery credit
  - Credit for oil and gas produced from marginal wells
  - Expensing of intangible drilling costs
  - Deduction for tertiary injectants
  - Exception to passive loss limitation for working interests in oil and natural gas properties
  - Percentage depletion for oil and natural gas wells
  - Domestic manufacturing deduction for oil and natural gas companies
  - Geological and geophysical amortization period for independent producers increased to seven years
- Coal tax expenditures
  - Expensing of exploration and development costs
  - Percentage depletion for hard mineral fossil fuels
  - Capital gains treatment for royalties
  - Domestic manufacturing deduction for coal and other hard mineral fossil fuels
- Timber tax expenditures
  - Expensing of multiperiod timber growing costs
  - Capital gains treatment of certain timber income
- Agriculture tax expenditures
  - Capital gains treatment of certain income from agricultural sales
  - Expensing of certain multiperiod agricultural production costs
  - Expensing of certain capital outlays including fertilizer and feed

- Exclusion of "inside buildup" of life insurance
- Business meals and entertainment deduction
- Exemption of credit union income
- Exemption of income of certain insurance companies operated by tax-exempt organizations
- Deduction for 25 percent of claims and expenses in excess of adjusted surplus for Blue Cross and Blue Shield organizations in existence on August 16, 1986, and similar organizations
- Exclusion of interest on private purpose bonds
- Last-in-first-out, or LIFO, and lower-cost-or-market, or LCM, accounting methods
- Ethanol tax credits

3. Payroll taxes

The CAP reform plan renews a call for "Modernizing Social Security and Ensuring its 75 Year Solvency" originally contained in the Center for American Progress report, "Building it Up, Not Tearing it Down." With respect to the payroll tax, the CAP reform plan would:

- Remove the Social Security payroll cap on the employer side of the payroll tax;
- Treat cafeteria plan benefits as Social Security wages, similar to salary reduction contributions to 401(k) plans, for purposes of calculating the employer share of Social Security tax.

4. Estate and gift taxes

The CAP reform plan returns the estate tax to its "2009 parameters" starting in 2012. Beginning in 2017, it increases the exemption amount for a married couple to $2.8 million and applies a progressive rate schedule ranging from 18 percent to 55 percent.

The CAP reform plan replaces the current step-up in basis to 100 percent of the property's fair market value at death with a step-up in basis to 50 percent of its fair market value, unless the heirs can establish that the decedent's basis was higher.

5. Excise taxes

Cigarette taxes

The CAP reform plan increases the existing Federal excise tax on cigarettes by 50 cents per pack.

Alcohol taxes

The CAP reform plan raises various existing Federal excise taxes on alcoholic beverages to a single levy of $16 per -proof gallon on all alcoholic beverages.

Internet gambling

The CAP reform plan imposes a regulatory framework for Internet gambling and collects a license fee from each authorized site equal to two percent of deposits into gambling accounts, with unauthorized bets or wagers subject to a 50 percent fee.

Superfund

The CAP reform plan reinstates Superfund taxes.

6. Other tax provisions

Systemic risk fee

The CAP reform plan imposes a new systemic risk fee of 0.15 percent on liabilities of large financial firms with more than $50 billion in assets.

Financial transaction tax

Under the CAP reform plan a new financial transaction tax applies to trading in stocks, bonds and derivatives. The tax rate is 0.117 percent on stocks and options trading, 0.002 percent on bonds, 0.002 percent on foreign exchange trading, and 0.005 percent on futures and swaps trading.

Oil import fee

The CAP reform plan imposes a $5 per-barrel fee on oil imports and "puts a price" on greenhouse gas emissions (*e.g.,* carbon dioxide).

H. A Proposal of the Roosevelt Institute Campus Network: Budget for a Millennial America[1586]

Summary

The Budget for a Millennial America, prepared by the Roosevelt Institute Campus Network, offers a long-term blueprint for Federal budget and tax reform (the "Roosevelt Plan"). The proposal intends to capture the priorities of college-aged "Millennials." On the tax side, the proposal's principal features include (1) modifying the individual rate structure, (2) cutting the corporate tax rate by three percentage points, (3) expanding the Social Security tax wage base, (4) imposing a financial transactions tax, (5) imposing a "too big to fail" bank tax, and (6) imposing a carbon tax. The proposal also eliminates a large number of unspecified corporate and individual tax expenditures with the goal of raising $550 billion per year in additional revenue.

Components

1. Individual income tax

The proposal creates six income tax rate brackets. These brackets adjust annually to reflect changes in national income distribution.

Roosevelt Plan Starting Tax Rate Brackets		
Single Filer Income	**Joint Filer Income**	**Tax Rate**
$0	$0	9.45%
$39,536.76	$79,073.53	15.75%
$65,894.61	$131,789.22	26.25%
$84,010.16	$168,020.31	31.50%
$208,668.94	$417,337.87	AMT tax threshold*
$709,679.84	$1,419,359.67	36.75%

*The AMT rate is 28 percent. The proposal does not specify the regular tax rate for this bracket.

The proposal reduces the cap on acquisition indebtedness eligible for a home mortgage interest tax benefit to $500,000 (down from $1 million) for primary residences and eliminates the benefit for secondary homes. The reduction is phased in over a five-year period, with the cap for eligible mortgages declining $100,000 per year beginning in 2013. The proposal changes the present-law deduction for home mortgage interest to a 15-percent credit.

The proposal eliminates the employer-provided health insurance tax exclusion. It also creates a refundable tax credit of $500 plus $50 per child for taxpayers earning less than $50,000 per year.

[1586] The proposal may be found on the Roosevelt Institute Campus Network's website at www.rooseveltcampusnetwork.org. Additional details of the proposal's tax components are summarized by the Roosevelt Institute Campus Network in the Peter G. Peterson Foundation's Solutions Initiative. Peter G. Peterson Foundation, "The Solutions Initiative," 2011 *Fiscal Summit, Solutions for America's Future*, May 2011, available at http://www.pgpf.org/~/media/88A2881EBE18412EB569ECFC626DA220.

2. Corporate income tax

The proposal cuts the corporate tax rate by three percent, making the top rate 32 percent and the bottom rate 12 percent.

3. Payroll taxes

The proposal modifies the present-law cap on annual earnings to which the Social Security payroll tax applies ($113,700 for 2013) such that it adjusts periodically to ensure a wage base that covers 90 percent of all wages earned. The proposal also imposes a new four percent payroll tax on all wages exceeding the modified annual cap. The proposal does not specify whether the four percent tax will be imposed on employees, employers, or both.

4. Estate and gift taxes

The proposal make no recommendations to change estate and gift taxes.

5. Excise taxes

The proposal repeals the gasoline excise tax. The proposal makes no mention of other motor fuel taxes, but their repeal would be consistent with the proposal's intention to replace the gasoline tax with a carbon tax.

6. Other taxes

The proposal creates an upstream carbon tax, which starts at $23 per ton and increases 5.6 percent each year.

The proposal creates a financial transactions tax that includes a 0.5 percent fee on stock trades, a 0.01 percent fee on bonds for each year remaining until maturity, a fee on futures contracts of 0.02 percent of the notional value of the underlying asset, a fee on options of 0.5 percent of the premium paid for the option, and a fee on interest rate swaps of 0.01 percent of the asset value for each year until the expiration of the agreement.

The proposal imposes a "too big to fail" financial activities tax of 25 percent on all banks (and the financial arms of non-bank corporations) with more than $200 billion in assets (indexed to inflation). The tax applies to wages and profits less capital formation costs.

I. Bipartisan Tax Fairness And Simplification Act of 2011, Introduced By Senators Wyden, Coats, and Begich

Overview

On April 5, 2011, Senator Wyden introduced (for himself, Senator Coats and Senator Begich), the "Bipartisan Tax Fairness And Simplification Act of 2011" (the "Wyden-Coats Plan").[1587] The Wyden-Coats Plan makes significant changes to the U.S. tax structure, changing both tax rates and allowable exemptions, deductions, and credits for both the individual income tax and the corporate income tax. Generally, these changes broaden the individual and corporate tax bases and lower statutory tax rates relative to present law. Average and marginal tax rates on most sources of income are reduced.

Components

1. Individual tax

The Wyden-Coats Plan provides three tax rate brackets for individuals: 15, 25, 35 percent. The plan makes the tax brackets and other tax provisions for married couples equal to twice the amount for unmarried taxpayers to reduce marriage penalties.

Table 31.−Statutory Tax Rates under the Wyden-Coats Plan

Individual Income Tax Rates under the Wyden-Coats Plan	
Income Bracket for Joint Filers	**Tax Rate**
up to $75,000	15 %
$75,000 - $140,000	25 %
$140,000 or more	35 %

Under the Wyden-Coats Plan, the alternative minimum tax is repealed.

The Wyden-Coats Plan significantly increases the size of the standard deduction, to $30,000 in the case of joint-filers. The Wyden-Coats Plan also permanently extends the expansion of the earned income credit (*i.e.*, the increased credit for families with three or more children and the mitigation of certain marriage penalties associated with the credit), the

[1587] S. 727 (April 5, 2011).

dependent care credit, and the child tax credit (*i.e.*, the lower earnings threshold for refundability), all of which are scheduled to expire at the end of 2017. The Plan also consolidates the various tax benefits for the payment of higher education expenses into one credit.

The Wyden-Coats Plan repeals the personal exemptions phaseout ("PEP") and the overall limitation on itemized deductions (known as the "Pease limitation"). The Plan also eliminates various deductions and exclusions, such as the exclusion on "cafeteria plans" and the "miscellaneous itemized deductions."

The Plan conforms the tax rates on capital gains and dividends to the individual income tax rate schedule, while providing a 35-percent exclusion for any capital gains or dividend income received by the taxpayer. Thus, the recognition of capital gains of individuals or the receipt of dividends results in a tax rate from 9.75 to 22.75 percent depending on the applicable individual rate bracket. Interest income is fully includable at regular income tax rates, with the exception for interest on municipal bonds, which under the Plan is included in income but qualifies for a non-refundable 25-percent tax credit.

The Wyden-Coats Plan replaces present-law individual retirement accounts ("IRAs") with one retirement account similar to the current Roth IRA (in which contributions are made on an after-tax basis, but returns on the earnings in the account are not subject to tax), subject to a yearly maximum of $5,000 in contributions (indexed for inflation). The Plan also creates a new savings vehicle, the American Dream Account, with a maximum yearly after-tax contribution of $2,000 (indexed for inflation), the proceeds of which could be used for any purpose.

2. Corporate and other business income tax

The Wyden-Coats Plan provides for a single corporate income tax rate of 24 percent. It makes additional modifications to the taxation of business entities, including: (a) providing for the unlimited expensing of depreciable assets and inventories for businesses with gross receipts of under $1,000,000; (b) eliminating depreciation on equipment in excess of alternative depreciation schedules for businesses other than small businesses; (c) indexing the corporate interest deduction for inflation; (d) eliminating the corporate alternative minimum tax; and (e) including active income of controlled foreign corporations in Subpart F income and applying per-country foreign tax credit rules.

The Plan also makes certain changes to tax administration to increase compliance, and changes the inflation indexation of many provisions in the Internal Revenue Code from the Consumer Price Index to the Chained Consumer Price Index.

3. Payroll taxes

The plan applies the Medicare taxes to all State and local government employees.

4. Estate and gift taxes

The plan makes no recommendation with respect to estate and gift taxes.

5. Excise taxes

The plan makes no recommendation with respect to excise taxes.

J. Tax Reduction and Reform Act of 2007, Introduced by Representative Rangel

Summary

The Tax Reduction and Reform Act of 2007 [1588] contains a number of tax reductions for individuals, a reduction in the corporate tax rate, and various other provisions. The bill also imposes a surtax on individual income above specified amounts. Among its tax reductions for individuals, the bill increases the standard deduction, repeals the alternative minimum tax, and increases the scope of the earned income credit and the amount of the refundable child credit.

For corporations, the bill reduces the maximum corporate tax rate from 35 percent to 30.5 percent. [1589] The bill contains certain other changes affecting business and investment. Among these, the bill repeals certain deductions and inventory methods, modifies the treatment of certain cross-border income, changes certain Self-Employment Contributions Act ("SECA") rules for service income of S corporation shareholders and partners of partnerships, and liberalizes the rules relating to debt financed income of tax-exempt entities earned through partnerships.

Several provisions of the bill (or similar provisions) have been enacted since its introduction: (1) reimpose prior-law phase outs of the personal exemption and overall limitation on itemized deductions for taxpayers with income above certain thresholds;[1590] (2) limit deferral of compensation through use of off-shore entities;[1591] (3) require basis reporting by brokers on sales of stock;[1592] and (4) clarify the economic substance doctrine, including the imposition of related penalties.[1593] The enacted provisions are not included below.

[1588] H.R. 3970, 110th Cong. (2007), introduced by Representative Charles Rangel on October 25, 2007, available at http://www.gpo.gov/fdsys/pkg/BILLS-110hr3970ih/pdf/BILLS-110hr3970ih.pdf.

[1589] The bill also extends a number of expiring provisions for one year. The extensions of expiring provisions are not described in this summary.

[1590] Enacted in the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 101.

[1591] Enacted in the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, Division C, sec. 801.

[1592] Enacted in the Energy Improvement and Extension Act of 2008, Pub. L. No. 110-343, Division B, sec.403.

[1593] Enacted in the Health Care and Education Reconciliation Act of 2012, Pub. L. No. 111-152, sec. 1409.

Components

1. Individual tax provisions

Standard deduction, earned income credit, refundable child credit, and alternative minimum tax

The bill permanently increases the standard deduction by an additional $850 for married couples filing jointly, $425 for single individuals and married persons filing separately, and $625 for heads of household. The bill increases the earned income credit percentage from 7.65 percent of earned income to 15.3 percent, and increases the overall limitation phase-out amount to $10,900. The bill also increases the amount of the refundable child credit by reducing the floor from an inflation-adjusted $10,000 to a permanent $8,500.[1594]

The bill repeals the alternative minimum tax ("AMT") on individuals. Instead, the bill imposes a surtax on taxpayers with incomes above a specified amount. This income level is to be set by the Secretary of the Treasury and determined by selecting an income level above which 90 percent of all married taxpayers would (but for repeal of such tax) be subject to tax under the AMT, but in no event less than $200,000. These taxpayers will pay a surtax of four percent on income in excess of that specified amount, and 4.6 percent on income in excess of $500,000 ($250,000 in the case of single taxpayers), which amounts are adjusted for future inflation. For these taxpayers, the bill also modifies calculation of the threshold amount for miscellaneous itemized deductions subject to the two percent floor. Such taxpayers would be allowed to deduct miscellaneous itemized expenses in any year to the extent those deductions exceed two percent of the taxpayer's adjusted gross income up to the specified amount, plus five percent of the adjusted gross income in excess of the threshold.[1595]

Other provisions

Carried interest

The bill requires investment fund managers to treat carried interest as ordinary income rather than capital gain.

Treatment of certain gains as ordinary income

The bill expands the present law rules under which certain gains on sales of depreciable property to a related party are treated as ordinary income. The bill explicitly includes partnership interests as a type of property subject to the rules. In addition, the bill treats parties as related if they have entered into a tax sharing agreement in which the seller obtains the benefits of the buyer's depreciation.

[1594] Legislation enacted in years following the bill's introduction, temporarily reduced the threshold. The present law non-indexed $3,000 expires after 2017. Sec. 24(d)(4).

[1595] This represents an increase over the present-law general disallowance of all such miscellaneous itemized deductions under the alternative minimum tax.

Recognition of ordinary income on exercise of certain S corporation stock options

The bill affects situations in which an S corporation has an employee stock ownership plan (ESOP) as a shareholder and grants an option to acquire stock of the S corporation. When the option is sold or exercised, the bill requires the holder of the option to recognize ordinary income to the extent of net S corporation income that was allocated to the ESOP but that would have been allocated to the option holder had the option stock been held by the option holder during the period the income was allocated to the ESOP. The bill imposes interest at the underpayment rate, measured from the time the income would have been so allocated to the option holder.

2. Corporate and business tax provisions

C corporation income tax provisions

The bill contains several provisions that would apply only to C corporations. First, the bill reduces the top corporate income tax rate from 35 percent to 30.5 percent. Second, the bill reduces to 60 percent (from 70 percent) the corporate dividends-received deduction applicable to a corporate shareholder that owns less than 20 percent of another company's stock; reduces to 70 percent (from 80 percent) the corporate dividends-received deduction applicable to a corporate shareholder that owns at least 20 percent but less than 80 percent of another company's stock; and repeals the net operating loss exception to the limitation on aggregate dividends-received deductions and provides instead for a carryover. Third, the bill imposes corporate-level tax on certain gain related to the substitution of a subsidiary's debt securities for parent debt securities in a corporate spin-off. Fourth, the bill prevents C corporations from using a special rule that allows accrual method taxpayers that perform certain services not to account for amounts that, on the basis of the taxpayer's experience, will not be collected. Fifth, the bill repeals the special rules for domestic international sales corporations.

Provisions affecting cross-border investment

The bill requires U.S. persons that defer income earned through a controlled foreign corporation (CFC) to defer the deductions associated with this income. Thus, U.S owners of a CFC are required to allocate deductions, such as interest and research and development, to deferred foreign income. These deductions are allowable only when the deferred income is repatriated back to the United States.

The bill also repeals the election to allocate interest on a world-wide basis. The world-wide interest allocation election was enacted in 2004 but has yet to take effect.

The bill modifies the foreign currency conversion rules for determination of foreign taxes and of a foreign corporation's earnings and profits.

The bill prevents foreign corporations that own entities in tax haven countries from avoiding tax on income earned in the United States. Specifically, the bill prohibits companies from routing income earned in the United States through structures in which a controlled U.S.

entity makes a deductible payment to a person in a country with which the U.S. has a tax treaty.[1596]

Other business income tax provisions

The bill contains several provisions that apply not only to C corporations but also to businesses in whatever form conducted (thus affecting the taxes of individuals that invest in passthrough entities, or that own sole proprietorships). The bill repeals the domestic production activities deduction currently available under section 199. The bill repeals the last-in, first-out ("LIFO") method of accounting for inventory currently permitted under section 472 and requires the income recognized as a result of a change in method to be taken into account over an eight-year period. The bill repeals the lower of cost or market method of valuing inventories currently permissible under section 471 and requires the valuation of inventories at cost.[1597] The bill also increases to 20-years the present law 15-year amortization period for section 197 intangibles.

At the same time, the bill makes permanent the small business expensing provisions of section 179 at $125,000[1598] and permanently includes computer software as property eligible for such expensing.

3. Payroll tax provision

Under the bill, shareholder-employees of S corporations that primarily provide services are generally subject to SECA taxes on the portion of their S corporation pro rata share that relates to the service business of the S corporation. The bill makes similar changes to the self-employment tax treatment of limited partners of partnerships that are engaged in a service business.

4. Estate and gift taxes

The bill makes no changes with regard to estate and gift taxes.

5. Excise taxes

The bill makes no changes with regard to excise taxes.

[1596] The bill does not affect multinational corporations incorporated in a treaty partner country.

[1597] This provision does not affect existing variations on the cost method (*e.g.*, the retail method), nor does it affect the present law treatment of subnormal goods.

[1598] The $125,000 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 $500,000. For taxable years beginning in 2010 through 2013, up to $500,000 of qualified property may be expensed, reduced by amounts placed in service that exceed $2 million.

6. Other

The bill allows tax-exempt entities to invest directly in investment funds that are in partnership form, without incurring unrelated business income tax due to debt-financed income.

K. A Proposal of the Heritage Foundation[1599]

Summary

The Heritage Foundation's proposal (the "Heritage plan") aims to reduce the size of government, reform the Federal tax system, and restructure entitlement programs. In terms of tax reform, the Heritage plan replaces all existing Federal income, payroll, and transfer taxes with a "modern flat tax." The plan also reforms Social Security and Medicare, repeals and replaces the Affordable Care Act,[1600] and reforms several other Federal spending programs, including those funded from tax-financed trust funds. Among other goals, the Heritage plan seeks to: (1) balance the Federal budget within 10 years at a level of not more than 18.5 percent of the economy as measured by gross domestic product ("GDP"); and (2) reduce the national debt to 30 percent of GDP within 25 years.

Components

1. Individual tax

In general

The Heritage plan replaces the current income, payroll, and transfer tax systems with a new, single-rate tax. Individuals are taxed uniformly on income spent on consumption, namely labor income and net borrowings. Net taxable income is determined by subtracting from such income the amount set aside in savings. Tax is paid on savings as such amounts are used to pay for goods or services.

Individual taxpayers are allowed three specific deductions, with all other individual deductions allowed under present law being eliminated. The three permitted deductions are for: (1) higher education expenses up to the average annual costs for tuition and expenses at a four-year public college or university; (2) charitable contributions; and (3) mortgage interest. A homeowner may elect to forgo the mortgage interest deduction, in which case the mortgage lender will not be taxed on the interest income.

The Heritage plan allows after-tax dollars to be placed in an account similar to a present-law Roth IRA until the account balance reaches $100,000. Account earnings and distributions are not taxed. The plan permits one such account per taxpayer.

[1599] "Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity," as submitted to the Peter G. Peterson Foundation as part of the Solutions Initiative. The full proposal and an executive summary are available at http://www.pgpf.org/solutionsinitiative.

[1600] The Patient Protection and Affordable Care Act (Pub. L. No. 111-148) and the Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152) are collectively referred to as the "Affordable Care Act." For an explanation of the excise tax provisions of the Affordable Care Act, see Joint Committee on Taxation, *Present Law and Background Relating to the Tax-Related Provisions in the Affordable Care Act* (JCX-6-12), March 4, 2013, pp. 38-46.

The tax treatment of non-cash compensation and deferred (*e.g.*, retirement) compensation is not specified.

Provisions for low-income working households and senior citizens

A health insurance tax credit with a maximum value of $2,000 for an individual or $3,500 for a couple or family is provided to offset the cost of employer-provided coverage or to assist with the purchase of coverage outside the workplace.[1601] The credit, which is advanceable, assignable, and available on a prorated basis, is phased out above specified income thresholds. The credit is designed to eliminate income tax for certain low-income workers. However, there is no requirement that individuals obtain health coverage, and a taxpayer that chooses to forgo coverage would not qualify for the credit. The plan also retains the earned income credit and excludes from income certain benefits provided by the Federal government through anti-poverty programs.

The Heritage plan reforms the Social Security and Medicare systems. Once those reforms are fully implemented, benefits received by a senior citizen under the programs are excluded from income. A "senior's standard exclusion" is available during a transition period. In addition, for seniors who remain in the workforce, the first $10,000 of wages and salary is not taxed.

Tax rate

A single, uniform tax rate for individuals and businesses will be set at a level designed to raise revenue not to exceed 18.5 percent of GDP and will be updated periodically. The Heritage Foundation estimates that, once fully phased in, the statutory individual and business rate will fall between 25 percent and 28 percent.

2. Business tax

In general

Under the Heritage plan, businesses are taxed on their domestic net cash flow. All compensation paid to employees and purchases from other businesses are immediately deductible from gross domestic receipts. The plan retains the alternative simplified research and development tax credit, but eliminates all other special provisions and credits allowed to businesses under present law.

The business tax base includes only income from domestic sales of goods and services. All foreign-source income is excluded. The business tax is lifted on cash flows from exports and levied on cash flows from imports.

[1601] The Heritage plan eliminates the present-law exclusion from income for employer-provided health insurance.

Tax rate

As stated above, when the Heritage plan is fully phased in, individuals and businesses will pay tax at a single, common rate designed to raise revenue not to exceed 18.5 percent of GDP. The new, lower business rate is phased in over time by reducing the tax rate by one percentage point per year from the current top marginal corporate rate of 35 percent until the business rate matches the individual rate.

3. Payroll taxes

The Heritage plan eliminates present-law payroll taxes, but retains the current wage income reporting systems. Revenue that would have been raised through the present-law payroll taxes is to be credited to the Social Security and Medicare trust funds.

4. Estate and gift taxes

The Heritage plan repeals the Federal estate and gift taxes. Gifts to individuals and transfers through an inheritance are deductible when made and are taxable to the recipient when spent on consumption.

5. Excise taxes

The Heritage plan eliminates all Federal excise taxes, except for excise taxes dedicated to specific trust funds. As an example, the gasoline tax is retained until the tax and its related highway program are transferred to the States.

6. Other

The Heritage plan includes transition rules designed to avoid imposition of burdens and to prevent tax windfalls resulting solely from a transition from the existing Federal tax system to the new system. For example, accrued tax assets (*e.g.*, interest on an existing mortgage and accrued tax credits) are available for use under the new system until exhausted. In addition, businesses may elect to be taxed under the current worldwide system for up to 10 years.

L. A Proposal by Authors Affiliated with the American Enterprise Institute

Summary

On May 2011, authors affiliated with the American Enterprise Institute ("AEI") submitted a plan to the Peter G. Petersen Foundation that made recommendations to reduce the U.S. budget deficit and limit the growth of the national debt.[1602] The AEI authors' proposal included recommendations to reform Medicare, Medicaid, and Social Security, and outlined a tax reform plan. The plan replaces the income tax system with a progressive consumption tax that has two key features: a graduated-rate household-level tax on wages and other compensation, and a flat tax on business cash flow. The proposal has a revenue target of 19.9 percent of gross domestic product ("GDP"), and aims to limit the national debt to no more than 60 percent of GDP over an approximately 25-year period.[1603]

Components

1. Household tax

General structure

The AEI authors' proposal repeals individual income taxes and establishes a household tax on wages and other compensation, including fringe benefits (such as employer-provided health insurance and employer contributions to defined contribution plans), that follows a graduated rate schedule with three rates: 15 percent, 25 percent, and 35 percent.[1604] A 15-percent rate applies to the first $50,000 of taxable compensation;[1605] a 25-percent rate applies to taxable compensation between $50,000 and $100,000; and a 35-percent rate applies to all taxable compensation above $100,000. The proposal eliminates the standard deduction and the head-of-household filing status.

Defined benefit payments are taxable upon receipt under the household tax, but contributions to defined benefit plans by employers and employees are deductible. Social Security payments and unemployment compensation are taxable, but other government payments (such as transfer payments) are not. Income received from savings, including interest, dividends, and capital gains, is exempt from tax. Business cash flows received by sole proprietors are

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[1602] See Joseph Antos, Andrew Biggs, Alex Brill, and Alan D. Viard, *Fiscal Solutions: A Balanced Plan for Fiscal Stability and Economic Growth*, May 25, 2011. The full proposal and executive summary are available at http://www.pgpf.org/solutionsinitiative.

[1603] The proposal aims to achieve the debt target in 2035.

[1604] The 15-percent and 25-percent tax rates may be changed so that proposal meets the revenue target of 19.9 percent of GDP.

[1605] Taxable compensation consists of wages and fringe benefits. Cafeteria plans are eliminated under the proposal.

treated as wages and subject to the household tax. However, business cash flows received by other entities are taxed only under the business tax, which is described later in this document.

Credits and other deductions

Households can deduct up to $3,000 of child care expenses for one child and up to $6,000 of expenses for two or more children, with the amounts indexed to the Chained Consumer Price Index ("chained CPI"). Households can also deduct employee business expenses in excess of two percent of wages.

Four tax credits are available: (1) a 15-percent refundable credit for charitable contributions in excess of an annual floor of $500, indexed to chained CPI; (2) a nonrefundable $500 child credit that is not subject to an income-based phase-out; (3) a refundable credit for the purchase of private health insurance; and (4) an earned income tax credit that is generally calculated following present-law tax rules.[1606] For the earned income tax credit, the income used in the calculations is that income which is subject to the household tax. While the maximum limit on investment income is eliminated, eligibility for the credit is subject to an asset-based test.

Transition rules

No new contributions to existing traditional IRAs, 401(k)s, or other savings accounts funded with pretax dollars are permitted. The household tax is applicable to withdrawals from these accounts, but the proposal imposes no penalties for early withdrawals and has no minimum distribution requirement. For both households and businesses, interest on debt securities and loans (such as mortgages) held before enactment of the proposal is taxable and deductible following present-law rules. However, the proposal does not describe the tax rates applicable to interest income derived from these debt instruments.[1607]

2. Business tax

General structure

The AEI authors' proposal repeals corporate income taxes and taxes businesses on a cash-flow basis for the goods and services they provide, so that investments are expensed rather than depreciated over time. The cash flows are subject to tax at a flat 35 percent rate, which is also the maximum rate under the household tax. Negative cash flows may be carried back for five years and carried forward indefinitely. Businesses, however, must pay interest on their carryforwards at the one-year Treasury rate.

[1606] All dollar amounts for the earned income tax credit are indexed to chained CPI.

[1607] For example, it is unclear whether interest income derived by individuals from these instruments is taxed at the top marginal tax rate that applies to them under the household tax, or if the relevant rate is that which is calculated using present-law income tax rules.

Although the proposal eliminates all corporate tax preferences, it establishes a permanent research tax credit with a flat rate that applies to research expenses on a non-incremental basis.[1608] The rate of the credit is set such that it has the same budgetary cost as the proposal to enhance, and make permanent, the research tax credit in the President's fiscal year 2012 budget.[1609]

Firms other than sole proprietorships must deduct reasonable compensation for labor provided by owners, who are then taxed on that compensation under the household tax.

Taxation of cross-border transactions

Under the proposal, cash flows from cross-border transactions are generally taxed on an origin basis, so that only those cash flows derived from goods and services produced in the United States are taxed at the 35-percent rate. Cash flows from financial transactions (such as dividend payments) between domestic firms and related foreign parties are taxed at the 35-percent rate as well. No foreign tax credits are available to offset taxes paid on foreign-source income. The proposal does not describe how foreign tax credits are treated in transition.

Taxation of financial intermediaries

Cash flows from goods and services provided by financial intermediaries to households, as well as purely financial transactions (such as loans), are taxed on a cash-flow basis. No tax is imposed on transactions between businesses and financial intermediaries, except in the case where an explicit fee is charged for the service provided by the financial intermediary. In that situation, the fee received by the financial intermediary is subject to tax and deductible by the business.

Taxation of non-business sector

The cash flows generated by Federal, State, and local governments, as well as nonprofit institutions, are exempt from tax.

Transition rules

Investments made prior to the effective date of the proposal are subject to a number of transition rules.[1610] Investments made in the (approximately) 1.5-year period prior to the

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[1608] Only expenses associated with research "undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field" are eligible for the credit. See Joseph Antos, Andrew Biggs, Alex Brill, and Alan D. Viard, *Fiscal Solutions: A Balanced Plan for Fiscal Stability and Economic Growth*, May 25, 2011, p. 23.

[1609] For a description of the President's proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-2011), June 2011, pp. 51-70.

[1610] At the time it was written, the proposal's effective date was January 1, 2013. The effective date described in this document does not refer to a specific date in time. For ease of exposition, when the proposal uses specific time periods for its transition rules, the time periods mentioned in this document are defined relative to the effective date.

effective date of the proposal may be expensed.[1611] Four-percent of the value of depreciation and cost-of-goods-sold deductions in place at the end of the taxable year prior to enactment (as well as the value of prior-law credit and loss carryforwards) may be deducted by firms each year over the 25-year period following enactment of the proposal.[1612] The transition rules for the tax treatment of interest from existing debt instruments are the same as those described for the household tax.

3. Payroll taxes

Wages and fringe benefits included in the household-tax base are also subject to payroll taxes. Self-employment earnings are calculated following the same rules used to determine the tax base for the household and business taxes.

Individuals aged 62 or older are not required to pay payroll or self-employment taxes.

4. Estate and gift taxes

The proposal repeals the estate and gift taxes.

5. Excise taxes

Carbon tax

The proposal introduces a carbon tax with a phased-in rate that mimics the implicit tax rate on CO_2 equivalents in Revenue Option 35 of the Congressional Budget Office's March 2011 publication, *Reducing the Deficit: Spending and Revenue Options*, which described a cap-and-trade program.[1613]

Other excise taxes

The proposal repeals all excise taxes enacted in the Affordable Care Act.[1614]

[1611] Under the proposal, businesses may expense investments made from May 25, 2011, through December 31, 2012. This is approximately the 1.5-year period prior to the effective date contemplated in the proposal.

[1612] Under the proposal, businesses may deduct the value of any unclaimed depreciation allowances and cost-of-goods-sold deductions from 2013 to 2037, which is the 25-year period following the effective date of the proposal at the time it was written.

[1613] Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, March 2011, pp. 205-206.

[1614] The Patient Protection and Affordable Care Act (Pub. L. No. 111-148) and the Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152) are collectively referred to as the "Affordable Care Act." For an explanation of the excise tax provisions of the Affordable Care Act, see Joint Committee on Taxation, *Present Law and Background Relating to the Tax-Related Provisions in the Affordable Care Act* (JCX-6-12), March 4, 2013, pp. 38-46.

M. The Fair Tax Act of 2013, Introduced By Representative Woodall, *et. al.*

Summary

The "Fair Tax Act of 2013,"[1615] (the "Fair Tax"), repeals all Federal income, employment, and estate and gift taxes. These taxes are replaced by a national retail sales tax, which, for 2015, is imposed at a rate of 23 percent of the gross payments for the use or consumption of taxable goods or services.

In design, the Fair Tax is similar to a State retail sales tax, although the Fair Tax is imposed on a base that is significantly broader than most State sales taxes.[1616] The Fair Tax incorporates a monthly rebate mechanism as a means of relieving low-income families of the burden of paying tax on this expanded base of goods and services.

Components

1. Individual income tax

The individual income tax is repealed.

2. Corporate income tax (and business-related provisions for pass-through entities)

All corporate income taxes are repealed.

3. Payroll taxes

All payroll taxes are repealed.

4. Estate and gift taxes

All estate and gift taxes are repealed.

5. Excise taxes

Excise taxes are unchanged by the Fair Tax.

6. Other

The Fair Tax repeals all Federal income, employment, and estate and gift taxes. These taxes are replaced by a national sales tax, which, for 2015, is imposed at a rate of 23 percent of the gross payments for the use or consumption of taxable goods or services.

[1615] H.R. 25, 113th Cong. (2013); S. 122, 113th Cong. (2013).

[1616] Although no state has the same tax base, as a general matter food for preparation and consumption in the home is generally not subject to tax, nor is prescription medication. These items would be subject to tax under the Fair Tax.

Rate

For 2015, the Fair Tax is imposed at a rate of 23 percent. After 2015, the rate of the sales tax will vary. The rate is determined using the sum of three components: (1) the general revenue rate; (2) the old-age, survivors, and disability insurance rate; and (3) the hospital insurance rate. The general revenue rate is 14.91 percent, and is fixed. The old-age, survivors and disability insurance rate is the sales tax rate necessary to raise the same amount of revenue that would have been raised had a 12.4 percent tax on the Social Security wage base (including income derived from self-employment) been levied. The hospital insurance rate is the sales tax rate necessary to raise the same amount of revenue that would have been raised had a 2.9 percent tax on the Medicare wage base (including income derived from self-employment) been levied.

The Fair Tax imposes what is known as a "tax inclusive" sales tax, which imposes a tax on the gross payment amount. In contrast, most State sales taxes are considered to be "tax exclusive," which imposes a tax on the pre-tax sales proceeds. A tax levied under a "tax exclusive" model would have a higher stated rate in order to achieve the same revenue goals.[1617] The retail sales tax is imposed only on the final point of purchase of new goods and services for personal consumption. Neither used items, nor business-to-business purchases for the production of goods and services, are subject to the sales tax.

Tax Base

The Fair Tax imposes a tax on the retail sale of any taxable property or services. These include (i) any property (including leaseholds of any term or rents with respect to such property, but excluding intangible property and used property); and (ii) any service (including any financial intermediation services). In the case of a taxable employer,[1618] wages paid to employees are considered amounts paid for a service, and thus subject to the tax. Other than those wages paid by taxable employers described above, the Fair Tax is not imposed on any wages paid to an employee by (i) an employer in its regular trade or business; (ii) an employer that is a not-for-profit organization; (iii) an employer that is a government enterprise, or (iv) a taxable employer to employees directly providing education and training.

The tax is not imposed on any taxable property or service purchased for a business purpose in a trade or business. This includes property that was purchased by a person engaged in a trade or business that is used (i) for resale; (ii) to produce, provide, render, or sell taxable property or services; or (iii) in furtherance of other bona fide business purposes. Additionally, no tax is imposed on any taxable property or service purchased for an investment purpose and held exclusively for an investment purpose (*i.e.*, property purchased exclusively for purposes of

[1617] By way of example, under the Fair Tax, assume a seller was willing to sell an item such that, net after taxes, the seller's revenue was $100. The Fair Tax levies a 23-percent tax on gross payments, such that a vendor would have to charge $129.87 in order to receive the full $100 after taxes are imposed. Thus, under a traditional state sales tax model, the tax-inclusive 23-percent rate would translate to a 29.87-percent tax-exclusive rate.

[1618] A taxable employer is (1) any household employing domestic servants; and (2) any government except for government enterprises. A government enterprise is any entity owned or operated by a Federal, State, or local governmental unit or political subdivision that receives gross payments from private persons.

appreciation or the production of income, but not entailing more than minor personal efforts). Finally, the tax is not imposed on exports from the United States, for use or consumption outside of the United States. Consequently, the tax is inherently border adjusted. U.S. exports are not subject to the tax, but imports are taxed when sold at retail in the United States.

Family consumption allowance

Each qualified family is eligible to receive a sales tax rebate each month. The sales tax rebate is an amount equal to the product of the rate of tax (*i.e.*, the 23-percent tax-inclusive rate in 2015) and the monthly poverty level. A qualified family is one or more members of the same family sharing a common residence. In order to receive the family consumption allowance, a qualified family must register with the sales tax administering authority, in a form provided by the Secretary of the Treasury. Registration is not mandatory, although it is required in order to receive the rebate.

The monthly poverty level is (a) one-twelfth of the annual level determined by the Department of Health and Human Services poverty guidelines for a particular family size; and (b) in the case of families that include a married couple, one-twelfth of the annual marriage penalty elimination amount.[1619]

The rebates are to be mailed on a monthly basis by the Social Security Administration.

Collection

With certain exceptions, all sales taxes imposed under the Fair Tax are to be collected and remitted by the seller of the taxable property or services (including financial intermediation services). In the case of taxable property or services purchased outside of the United States and imported into the United States for use or consumption in the United States, the purchaser is required to remit the tax owed on such purchase.

The sales tax administering authorities are responsible for collecting all taxes imposed by the Fair Tax. Sales tax administering authorities are State agencies designed to collect and administer the national sales tax (in certain circumstances the Federal government acts as the administering authority). Administering States shall enter into an agreement with the United States that provides for the administration of the Fair Tax, including provisions for the expeditious transfer of funds, contact officers, dispute resolution, information exchange, confidentiality, taxpayer rights, and other matters. Administering States may retain an administration fee equal to 0.25 percent of the amounts otherwise required to be remitted to the United States.

[1619] The marriage penalty elimination amount is the difference between the poverty level for two single persons, and the poverty level of a family of two.

Social Insurance Programs

The Fair Tax requires that the Treasury Secretary allocate the revenue received by virtue of the Fair Tax in such a manner that the Old-Age, Survivors Insurance and Disability, the hospital insurance, and Federal supplementary medical insurance trust funds all receive funding in proportion to the rates associated with those trust funds. Thus, if in a future year, the general revenue rate is 14.91 percent, the old-age, survivors and disability insurance rate is six percent, and the hospital insurance rate is three percent, the Secretary is required to allocate 25.09 percent[1620] of the revenue to the Old-Age, Survivors Insurance and Disability trust fund.

[1620] This value is derived by computing 6/(14.91+6+3).

III. SUMMARY OF SUGGESTIONS AND COMMENTS RECEIVED BY THE WORKING GROUPS

A. Overview

The working groups received a substantial number of suggestions and comments from stakeholders, academics and think tanks, practitioners, the general public, and colleagues in the House of Representatives. All of the suggestions and comments submitted to the working groups remain available at http://waysandmeans.house.gov/taxreform/workinggroups.htm.

In the pages below, the Joint Committee staff catalogues and summarizes the various suggestions and comments received for each working group topic area. The Joint Committee staff has not attempted to summarize individually each suggestion or comment, to fully describe all the details of any particular suggestion, or to summarize any rationale offered for the suggestion. Rather the Joint Committee staff has attempted to catalogue and describe the various suggestions, comments, and concerns submitted to the working groups. Towards this end, the Joint Committee staff has grouped together comments within topic areas where appropriate. In a limited number of cases the Joint Committee staff has reassigned certain suggestions and comments delivered to one working group to the topic area of another working group. In addition, a number of suggestions and comments either related to no specific working group or applied to all working groups. The last section below, Part IV.L, catalogues and describes these suggestions and comments.

B. Working Group on Charitable/Exempt Organizations

The Working Group on Charitable/Exempt Organizations (the "Working Group") received public comments that cover a wide range of issues, which are summarized in this section. The summaries are organized into four broad categories: (1) the charitable deduction; (2) tax exempt status; (3) reporting, disclosure, and tax administration; (4) the exclusion from gross income for qualified charitable distributions from an individual retirement arrangement ("IRA"); and (5) comments submitted by Indian tribal governments.

1. The charitable deduction

General support for preservation of the charitable deduction or opposition to changes to the charitable deduction

Several comments urge Congress to retain the charitable deduction in its present form. Other comments argue that the value of present-law incentives for charitable deductions should not be reduced, or that Congress should proceed with caution when considering changes to the deduction to ensure that changes do not cause a reduction in the overall level of charitable giving. Other comments more specifically oppose recent proposals to limit the deductibility of charitable contributions, including:

- The President's fiscal year 2014 budget proposal to limit the value of certain tax expenditures, including the charitable deduction, to 28 percent;
- Dollar caps on deductions, including the deduction for charitable contributions;
- Conversion of the charitable deduction into a credit; or
- Allowing a deduction only for charitable contributions in excess of a specified amount, or "floor."

Some comments urge elimination of the present-law overall limitation on itemized deductions in section 68 of the Code, sometimes referred to as the "Pease limitation," or seek removal of charitable contributions from the Pease limitation.

Other commentary urges Congress to resist calls to treat certain section 501(c)(3) charitable organizations, such as cultural organizations, differently from organizations that serve basic human needs of food and shelter.

General support for reform of the charitable deduction

Several comments express support for reforming or modifying the charitable deduction, including by:

- Converting the charitable deduction into a 28-percent "itemized credit";
- Adopting an alternative to the current tax incentives for charitable giving if the alternatives would achieve similar results; or
- Allowing non-itemizing taxpayers to deduct charitable contributions.

Charitable contributions of property

Several submissions relate specifically to non-cash charitable contributions. The submissions urge Congress to:

- Maintain the present-law deduction rules for charitable contributions of non-cash property;
- Maintain the present fair-market-value deduction for contributions of appreciated property, particularly where the donated property is used by the recipient charity in an exempt function;
- Limit the deduction to basis for contributions of appreciated property;
- Maintain present-law processes for valuing contributions of property;
- Simplify present-law valuation rules and require the IRS to provide more guidance regarding the valuation of property contributions, similar to the valuation lists some charities provide to donors;
- Enact an intermediate sanction (*i.e.*, a sanction less severe than denial of the deduction) for minor, inadvertent failures adequately to substantiate a contribution of property (substantiation "foot faults");
- Allow artists to deduct the fair market value of donated, self-created artworks;
- Repeal or modify the rules for "fractional contributions" of tangible personal property (such as artworks) enacted as part of the Pension Protection Act of 2006;
- Repeal or modify legislation enacted in 2004 that amended the charitable deduction rules for contributions of automobiles and other vehicles;
- Make permanent the temporary present-law provision that allows increased percentage limits and an extended carryforward period for certain qualified conservation contributions (*i.e.*, conservation easements) by farmers, ranchers, and in some cases other individual taxpayers; or
- Make permanent the temporary provision under which an S corporation shareholder's basis in his or her shares is reduced by the shareholder's pro rata share of the adjusted basis of property contributed by the S corporation to charity.

Charitable contributions of inventory

Several comments address the "enhanced deduction" rules under section 170(e)(3) for charitable contributions of inventory of the taxpayer. The comments would make the following changes to present law:

- Expand the permanent, present-law enhanced deduction for inventory property so that contributions by any type of business entity, whether or not a C corporation, could qualify for the enhanced deduction;

- Expand the permissible uses of donated property to include "fundraising events and campaigns that benefit the ill, needy and/or minors within a local community" for purposes of the permanent, present-law enhanced deduction;
- Make permanent the temporary provision that allows businesses other than C corporations to qualify for the enhanced deduction for contributions of food inventory; and
- Expand the food donation provision to allow certain cash basis taxpayers who qualify for the provision to assume a basis equal to 25 percent of fair market value, include special rules for valuing the food inventory, and make other modifications.

Other comments relating to the charitable deduction

Other submissions related to the charitable deduction that do not fit within the above categories include:

- Proposals to allow an organization to qualify as an eligible recipient of charitable contributions even if it makes grants to a section 501(c)(7) social organization (such as a college fraternity or sorority) for the provision of collegiate housing;
- A proposal to allow the IRS to set and periodically modify the standard charitable mileage rate;
- A proposal to allow taxpayers who make donations through April 15 of a year to elect to deduct the contributions on their prior-year income tax returns;
- A proposal to impose a $1,000 per year floor on charitable contributions for which the donor received a non-trivial return benefit;
- A proposal to retain rules under section 274(l) that set aside limits that otherwise would apply to deductions of entertainment expenses for attendance at charitable sports events;
- A proposal to modify the rules under which electing small business trusts deduct charitable contributions attributed to an S corporation; and
- A proposal to enact tax laws that support and encourage the use of donor advised funds.

2. Tax-exempt status

In general

Several comments submitted to the Working Group make broad policy recommendations relating to the tax-exempt sector. These comments, for example, recommend that Congress:

- Carefully consider how any changes to the tax law will affect the nonprofit sector;
- Consider the value of foundation grant making on the economy when evaluating possible changes to the tax laws; and

- Oppose attempts to preempt State and local taxing authority, and preserve the ability of local officials to make tax policy decisions at the local level.

Public charity status and private foundation operating rules

Several comments relate either to the private foundation operational rules or to private foundation versus public charity status. These comments include proposals to:

- Repeal the excise tax on the net investment income of private foundations under section 4940 of the Code;
- Simplify the private foundation excise tax, including proposals to replace the present-law two-rate structure with a single-rate structure, with the rate set at one percent, a revenue-neutral rate, or an unspecified rate;
- Allow non-private foundation status for agricultural research organizations, applying rules similar to the present-law rules for medical research organizations;
- Allow grants from an Indian tribal government to be treated as public support for purposes of the section 509(a) public support tests used in determining public charity versus private foundation status;
- Allow organizations formed to support Indian tribal governments to be classified as supporting organizations under section 509(a)(3); and
- Create a new exception to section 509(f)(2), which disallows section 509(a)(3) supporting organization status to an organization that accepts certain gifts.

Unrelated business income tax ("UBIT")

Other submissions relate to the taxation of unrelated business income of exempt organizations. Such submissions include proposals to:

- Make permanent a temporary provision that modifies section 512(b)(13) to include in the unrelated business taxable income of a parent exempt organization only certain payments of passive income from a controlled subsidiary that exceed fair market value;
- Expand the above-described section 512(b)(13) rule to payments made pursuant to new contracts;
- Retain the qualified corporate sponsorship rules under section 513(i);
- Create an exception to the unrelated debt-financed income rules of section 514 to allow exempt organizations to invest in certain securities and commodities directly, without the need for a "blocker" entity;
- Modify or expand the present law real estate exception to the debt-financed income rules under section 514(c)(9) to include acquisition indebtedness related to real property acquired by other types of organizations;

- Extend the UBIT rules to employee stock ownership plans ("ESOPs") and government-affiliated entities; and
- Consider the diversity of the tax-exempt sector when evaluating any changes to the unrelated business income tax rules.

Specific types of tax-exempt organizations

A number of submissions include proposals related to specific types of tax-exempt organizations. These submissions urge Congress to:

- Maintain the tax exemption for certain rural electric cooperatives;
- Provide for tax exemption for certain cooperative group self-insured workers' compensation insurance pools;
- Maintain the tax exemption under section 501(c)(8) for fraternal beneficiary societies, orders, or associations;
- Maintain the tax exemption for Federal and State credit unions;
- Take a comprehensive view of community benefit for purposes of determining whether a hospital is exempt from tax under section 501(c)(3) and not enact a requirement that tax-exempt hospitals provide a specified minimum amount of charity care;
- Decrease the minimum required annual distribution amount for new charitable remainder trusts to three percent;
- Relax the requirement in section 1605 of the Tax Reform Act of 1986 that, to qualify for tax-exempt status, 80 percent of Washington Research Foundation's gross revenues must be from the provision of services to qualified organizations located in Washington State; and
- Clarify that the gift tax does not apply to contributions to section 501(c)(4) social welfare organizations.

3. Reporting, disclosure, or tax administration

Several comments relate to filing requirements or other administrative rules for tax-exempt organizations. These comments include proposals to:

- Exclude from the annual return filing requirements for charitable split-interest trusts those trusts whose only charitable deductions are passed through to them from a flow-through entity, such as an S corporation, limited liability company, or partnership;
- Allow a single six-month automatic extension for all Form 990-series exempt organization annual returns, as well as certain other information, excise, and income tax returns of tax-exempt organizations;
- Require the IRS to follow the applicable provisions of the Administrative Procedure Act when issuing tax-exempt organization forms and instructions; and

- Eliminate the following three special rules for churches: (1) the exemption of churches from the requirement that section 501(c)(3) organizations apply for tax-exempt status; (2) the exemption of churches from the requirement that section 501(c)(3) organizations file an annual Form 990 series return; and (3) the restrictions on church tax inquiries and audits under section 7611.

4. Exclusion from gross income for qualified charitable distributions from an Individual Retirement Arrangement ("IRA")

Finally, several submissions relate to a temporary provision under present law that allows an IRA owner age 70-1/2 or older to exclude from gross income up to $100,000 per year of distributions directly from an IRA to charity ("qualified charitable distributions"). The submissions include proposals to:

- Make the temporary provision permanent; and
- Expand the exclusion from gross income for qualified charitable distributions by, for example: allowing distributions for life-income gifts (gifts that include an income interest to the donor for life, with the remainder passing to charity); removing the annual dollar cap; allowing distributions to private foundations, supporting organizations, and donor advised funds; and/or lowering the age at which IRA owners may make a qualified charitable distribution to 65.

5. Miscellaneous comments submitted by Indian tribal governments

This subsection summarizes several submissions from Indian tribal governments that are not summarized elsewhere in this report.[1621] These submissions:

- Generally note that Indian tribal governments are not treated the same as other governments for all purposes and seek parity of treatment;
- Discuss the exclusion from gross income of individual tribal citizens under the general welfare doctrine. In general, the submissions urge Congress to enact legislation clarifying that gross income of a tribal member does not include the value of qualified Indian general welfare benefits;
- Urge enactment of the following proposals (as well as legislation relating to the general welfare doctrine, described above): (1) immunize from taxation income earned on tribal trust or restricted fee lands; (2) establish a tribal empowerment zone demonstration project; (3) immunize from taxation tribe-to-tribe trade and investment; (4) allow transfer of renewable energy tax credits for Indian Country projects; (5) allow a 100 percent credit for income taxes paid or monies donated to a

[1621] Submissions related to private foundation status are discussed above in the subsection discussing public charity status and private foundation operational rules. Comments related to tribal pension plans are discussed in connection with submissions to the pensions and retirement working group. Comments from tribal governments related to tax-exempt bonds are discussed together with other tax-exempt bond-related submissions in a separate section, below.

tribal government; (6) restrict the auditing of tribal governments; (7) recognize the tax immunity of tribal corporate entities; and (8) establish an Indian Country taxation self-governance program within the Treasury Department;

- Seek an expansion of the New Markets Tax Credit to all Indian trust lands;
- Request the extension of certain provisions that benefit Indian tribes, including the allowance for accelerated depreciation, the Indian wage and health credit, the Indian coal tax credit, the Indian employment tax credit, and various other renewable energy production and investment tax credits;
- Propose amending section 1361 to allow Federally recognized Indian tribal governments and their wholly owned entities to be shareholders in an S corporation;
- Propose modifying the base year for the Indian employment tax credit from 1993 to the average of qualified wages and health insurance costs for the two tax years prior to the current year;
- Propose allowing Indian tribes to participate in the imposition and collection of sales taxes under any Federal program relating to the facilitation, streamlining, or simplification of the collection of sales tax on remote sales;
- Propose exempting Indian tribal government distributions (whether derived from gaming or other income) from the "kiddie tax";[1622]
- Propose repealing the essential governmental function test imposed by section 7871(b) with regard to excise tax exemptions; and
- Propose affording Indian tribal governments full parity with State and local governments with regard to excise tax exemptions and treatment, to the extent not already provided.

[1622] Sec. 1(g).

C. Working Group on Debt, Equity, and Capital

Comments relating to deductibility of interest expense

The public submissions received by the Working Group with respect to the deductibility of interest expense suggest:

- Retaining the deductibility of interest expense generally;
- Retaining the deductibility of interest for all businesses;
- Taking a holistic rather than a piecemeal approach to deductibility of interest expense if changing the relative tax incentives for debt and equity;
- Denying a deduction for interest expense that represents credit risk;
- Reflecting differences in the function of interest expense for financial and nonfinancial businesses in the event of new limitations on interest deductibility.

Comments relating to the tax treatment of dividends on stock

The public submissions received by the Working Group relating to the tax treatment of dividends on stock suggest:

- Providing low tax rates on dividend income;
- Retaining the present-law statutory top rate on qualified dividends paid by C corporations;
- Treating dividends as ordinary income subject to the top individual tax rate; keeping the maximum 20 percent statutory tax rate (exclusive of the additional 3.8-percent tax on net investment income) on dividends and on capital gains the same, and lower than tax rate on ordinary income;
- Providing for uniform treatment of business profits by permitting a deduction for all dividends paid.

Comments on the tax treatment of capital gains

The public submissions received by the Working Group with respect to the tax treatment of capital gains suggest:

- Retaining low rates on capital gains;
- Specifically retaining the present-law 20 percent top statutory tax rate (exclusive of the additional 3.8-percent tax on net investment income) on capital gains of individuals;
- Taxing capital gains at a maximum 28 percent rate as under the 1986 Tax Reform Act;
- Taxing publicly traded stock received in a corporate merger like cash received;

- Treating equity (stock) like an option for tax purposes when the corporation's debt-equity ratio exceeds a threshold;
- Treating the first cash received in deferred payment sales as taxable boot and not providing capital gain treatment beyond the first year following the transaction;
- Following a wash sale, prohibiting the suspended loss from being transferred between taxpayers or between related parties;
- When a taxpayer sells stock and fungible stock is retained, requiring gain to be calculated to maximize gain and bring basis up to value;
- Providing that short sales and option issuances give rise to gain first, not recovery of basis first, if the taxpayer holds the underlying property;
- Retaining capital gains tax treatment of assets and real estate used in farming and ranching businesses;
- Retaining capital gains treatment for proceeds of timber cutting and sale of standing trees;
- Retaining tax-free treatment (with basis reduction) for exchanges of like-kind property of businesses, while simplifying the rules by eliminating requirements such as restrictions on the proceeds of relinquished property and the requirement of notice that rights are assigned to an intermediary;
- Requiring standardized brokerage reporting on Form 1099s.

Comments relating to carried interests

The public submissions received by the Working Group relating to the tax treatment of carried interests suggest:

- Preserving capital gain treatment for all carried interests;
- Preserving capital gain treatment for carried interests of venture capital firms;
- Preserving capital gain treatment for carried interests of developers of commercial real estate, including apartment buildings;
- Preserving capital gain treatment for carried interests of all real estate partnerships and family partnerships;
- Counting as contributed capital for carried interest purposes the amounts a developer put at risk prior to creation of the partnership;
- Maintaining present-law tax treatment of businesses organized as partnerships, limited liability companies, S corporations, and sole proprietorships, regardless of their size.

Comments relating to other tax rules

The public submissions received by the Working Group also addressed a variety of other topics relating to debt, equity, and capital. Those comments suggest:

- Treating the choice to lease or to finance the acquisition of equipment in a tax-neutral manner;
- Providing that a lending or finance business encompasses not only lenders but also firms engaged in leasing assets, for purposes of the tax treatment of financing income;
- Retaining an accelerated depreciation system;
- Retaining an accelerated depreciation system for capital intensive businesses;
- Simplifying the accelerated depreciation rules by eliminating the AMT depreciation preference and by shortening recovery periods while using the straight-line method to approximate accelerated depreciation;
- Not reinstating complex bonus depreciation;
- Retaining present-law section 179 expensing for the cost of depreciable assets at current levels;
- Providing a limited exclusion from income for debt forgiveness targeted to small businesses;
- For debt forgiveness, restoring and making permanent the exceptions to cancellation of indebtedness income for qualified business debt (with a basis reduction to depreciable property), for equity-for-debt exchanges of corporations and partnerships, and for qualified principal residence debt, as well as allowing partners to claim their shares of partnership debt under a partner-level insolvency exception, providing that forgiveness of debt owed to a partner is nontaxable to the extent of the partner's basis in the debt, providing that state law exemptions for retirement and other assets apply, and treating nondeductible interest as deductible for purposes of exceptions to cancellation of indebtedness income rules;
- Retaining the deduction for timber growing costs and the deduction and amortization treatment of reforestation costs;
- Retaining and enhancing the rehabilitation tax credit, particularly with respect to certified historic structures;
- Making the new markets tax credit permanent at $5 billion authority per year and allowing the new markets tax credit to offset alternative minimum tax liability.

Comments relating to goals for tax reform generally

The public submissions received by the Working Group with respect to general goals for tax reform suggest:

- Lowering the tax rate on all business income;
- Lowering the tax rate on corporate income;
- Lowering the corporate tax rate to 25 percent;
- Reforming both the corporate and the individual tax rules at the same time;

- Simultaneously lowering corporate tax rates and individual tax rates paid by owners of businesses in passthrough form;
- For passthrough entities such as partnerships and S corporations, refraining from increasing their owners' tax rate or reducing their owners' deductions and credits in order to offset a reduction in the corporate tax rate;
- Addressing the uncertainty or instability of the tax rules due to the temporary nature of business and other tax provisions;
- Adopting tax reform proposals to promote economic growth, competition, fairness, and predictability;
- Achieving tax reform on a revenue neutral basis;
- Providing simple, predictable, and easy to understand rules and allowing the marketplace rather than the tax system to allocate capital and resources through comprehensive tax reform;
- Providing transition rules that take account of existing deferred tax assets and liabilities for financial accounting purposes, treatment of existing debt, and tax accounting for existing inventory;
- Eliminating tax shelters by taxing individuals at a flat 10-percent rate (five percent if below the poverty line) on gross income and ending deferral on foreign-earned income of corporations;
- To the extent a concept of net interest expense is relevant to tax reform proposals, ensuring that lease payments include a component attributable to interest as part of any calculation of a leasing company's net interest.

D. Working Group on Education and Family Benefits

Below is a summary of comments that were submitted to the Ways and Means Committee Tax Reform Working Group on Education and Family Benefits ("Working Group").

1. Comments on education provisions

The public submissions received by the Working Group were varied in nature. Submissions suggested the following changes related to education provisions:

- Retaining all present-law provisions at their current levels (including making permanent the American Opportunity Tax Credit);
- Consolidating various credits and deductions such as the American Opportunity tax credit, the Hope credit, the deduction for tuition and fees, and the lifetime learning credit into a single tax credit for current expenditures;
- Providing full refundability of the AOTC, instituting a lifetime-dollar cap rather than a four-year cap, indexing the credit to inflation, delivering benefits at the time expenses are incurred rather than after filing season, lengthening the phase-out ranges, and increasing the benefit calculation to cover greater percentages of expenses;
- Aligning eligibility for higher education tax benefits with eligibility for Federal student aid and other tax provisions by amending or removing eligibility restrictions based on one's criminal record;
- Making permanent the above-the-line deduction for qualified tuition-related expenses;
- Relief from income inclusion and taxation upon the forgiveness of certain student loans;
- Eliminating the taxation of that portion of Pell grants used to pay for transportation, food, housing, or other costs of attending college to align with the definition of eligible expenses for federal student aid;
- Retaining, consolidating, or expanding tax benefits for saving for college (both section 529 plans and Coverdell education savings accounts);
- Retaining or expanding tax benefits for student loans;
- Coordinating all education-related provisions, such that all education-related provisions have the same AGI limitations, have the same eligible expenses, and are all indexed to inflation;
- Expanding outreach and education about the availability of higher education tax benefits;
- Extending tax-exempt bond status to private student loans which are not Federally-guaranteed;
- Repealing all of the tax benefits related to education;

- Increasing and making permanent the above-the-line deduction for teacher expenses.

2. Comments on family-related provisions

The public submissions received by the Working Group focused on a variety of issues related to tax benefits for families. Those submissions suggested:

- Retaining the present-law earned income credit and child tax credit (including making permanent those provisions of the earned income credit and child tax credit that expire at the end of 2017);
- Changing the annual payment of the earned income tax credit (currently a lump-sum refund during the tax filing season) to four equal quarterly payments during the course of the year;
- Increasing the EITC for childless workers and non-custodial parents, including by expanding eligibility to childless workers age 21 and older, increasing the phase-in and phase-out rates, adjusting the level of income at which the phase-in ends and the phase-out begins, and raising the maximum credit;
- Simplifying the rule governing how parents who are separated can claim the EITC, allowing filers who live with a qualifying child but do not claim the child for any tax benefit to claim the smaller EITC for workers not raising a child, and eliminating the EITC investment income test;
- Initiating a Congressional investigation into EITC claims to uncover abuses and better direct the credit to truly deserving individuals;
- Expanding the Saver's Credit by qualifying savings for reasons other than retirement;
- Retaining and improving the ability for taxpayers to purchase U.S. Savings Bonds with tax refunds, with additional suggestions including the ability to gift a Savings Bond using a portion of tax refunds, and allowing taxpayers without bank accounts to designate a portion of their tax refunds to purchase Savings Bonds;
- Amending the adoption tax credit to be refundable;
- Modifying the present-law adoption credit to allow Indian tribal determinations of "special needs";
- Creating a tax credit for the costs of in-vitro fertilization treatments;
- Modifying the present-law adoption credit to allow Indian tribal determinations of "special needs";
- Creating a structured savings incentive (similar to a 529 plan) for the care of persons with disabilities, known as "ABLE" accounts;
- Simplifying the "kiddie tax";
- Simplifying the definition of dependent child, with some submissions proposing one uniform definition and others advancing simplification but cautioning that complexity of the definition is inherent in the complexity of the modern family structures;

- Creating an expanded and refundable dependent care credit;
- Improving the collection of past-due child support from Federal tax refunds.

E. Working Group on Energy

In general

Comments submitted to the Energy Working Group include both broad and narrow proposals. The broad proposals include suggestions to eliminate all energy tax expenditures and adopt the Fair Tax or finance tax reform by imposing a carbon tax. Some slightly more narrow comments call for eliminating all tax expenditures benefiting renewable technologies or replacing them with a technology neutral approach. Other broad but sector specific proposals call for eliminating all tax expenditures relating to oil and gas extraction and production. Many comments, however, relate to specific Code sections and are summarized below.

Extraction and production

- Enhanced oil recovery credit (sec. 43): One comment suggests keeping the enhanced oil recovery credit.
- Amortization of geological and geophysical ("G&G") expenses (sec. 167(h)): One comment suggests keeping the present law G&G amortization schedule.
- Deduction for domestic production activities (sec. 199): Several comments suggest keeping section 199. One comment suggests that oil companies should be entitled to a full section 199 deduction.
- Deduction for intangible drilling costs ("IDCs") (secs. 263(c) and 291): A number of comments suggest retaining present law with respect to the recovery of IDCs.
- Last-in, first-out ("LIFO") method of accounting (sec. 472): Some comments suggest retaining LIFO accounting rules for inventory valuation.
- Percentage depletion deduction (sec. 613): Some comments suggest keeping percentage depletion.
- Capital gain treatment for certain coal royalties (sec. 631(c)): One comment suggests keeping this provision.
- Oil and gas extraction and production (secs. 43, 179C, 167(h), 199, 263(c), 291, 472, and 613): Some comments call for eliminating tax expenditures benefiting oil and gas extraction and production, including those listed above.

Transportation, transmission, and generation

- Renewable electricity production tax credit ("PTC") (sec. 45): Numerous comments call for either extending (long-term) or repealing the PTC. Other comments ask for specific modifications, such as (1) giving biomass power the same credit rate as wind power, (2) allowing private operators of municipally owned facilities to qualify for the PTC, or (3) expanding the PTC to cover waste heat, biogas, renewable chemicals, and other bio-based products. One comment calls for reducing the PTC and using the revenues to create a new "renewable power integration credit," which would provide

additional tax incentives to utilities as their reliance on intermittent sources of renewable power increases.

- Carbon dioxide sequestration credit (sec. 45Q): One comment suggests replacing the 75 million ton global cap on qualified carbon dioxide with a specified cap per facility placed in service.
- Nuclear power (secs. 45J and 468A): One comment suggests retaining the present-law tax incentives for nuclear power and requests that no new taxes or assessments be imposed to finance the Uranium Enrichment Decontamination and Decommissioning Fund.
- Energy investment tax credit (ITC) (sec. 48): Some comments call for extending this credit; others call for its repeal. Some comments propose modifying the credit. Modification proposals include: (1) allowing high efficiency biomass thermal combustion property to qualify; (2) providing the same credit rate for microturbines as for other qualifying property; (3) modifying the eligibility requirements for qualified combined heat and power property; (4) adding superconducting transmission lines to the list of qualified property; (5) adding algae fuel property to the list of qualified property; (6) removing the limitation on solar heating systems for commercial swimming pools; (7) adding offshore wind property to the list of qualified property; (8) adding utility-scale energy storage property to the list of qualified property; and (9) creating a "direct pay" option.
- Tax-exempt bonds for certain private energy-related projects (secs. 103, 141 and 146) and new clean renewable energy bonds ("CREBs") (sec. 54C): Some comments suggest expanding the use of private activity bonds, authorizing new CREB allocations, and creating other tax-preferred bond/financing provisions for renewable energy.
- Real estate investment trusts ("REITS") (sec. 856): One comment suggests modifying the real estate investment trust rules to make it easier for REITs to install solar, wind, and other renewable power generators on REIT-owned buildings.
- Taxation of cooperatives (sec. 1381): One comment suggests retaining the present-law taxation of electric cooperatives.
- Publicly traded partnerships (*i.e.* master-limited partnerships) (sec. 7704): Some comments suggest keeping the publicly traded partnership rules. Other comments suggest expanding the rules to permit renewable technology and energy storage companies to operate as publicly traded partnerships. One comment specifically advised against expanding the publicly traded partnership rules to include renewable technologies.

Vehicles, alternative fuels, and specialty manufacturing

- Alternative fuel refueling property credit (sec. 30C): Some comments suggest extending this credit. One comment suggests increasing the amount of credit-eligible business property to $100,000 per location. Another suggests new credits are needed to further encourage vehicle-to-grid technologies.

- Plug-in electric drive vehicle credit (sec. 30D): Some comments suggest extending this credit. Others suggest giving two- and three-wheeled vehicles the same credit calculation as other vehicles in section 30D.
- Biofuel and alternative fuel credits (secs. 40A, 6426, and 6427): Some comments suggest expanding renewable fuel incentives. Others call for their repeal. One comment calls for converting the biodiesel credit from a "blender's credit" into a "producer's credit."
- Credit for the production of low-sulfur diesel fuel and deduction for capital costs incurred in complying with Environmental Protection Agency (EPA) sulfur regulations (secs. 45H and 179B): One comment suggests conforming the period for incurring qualified compliance costs from the present law sunset date of December 31, 2009, to the EPA compliance date of June 1, 2010 (see secs. 45H(c)(2) and 179B(a)).
- New vehicle credit: One comment suggests the creation of a new tax credit for medium- and heavy-duty trucks that are plug-in hybrid electric vehicles, electric vehicles, bi-fuel natural gas vehicles, and non-conventional hybrids. Others call for the revival of the section 30B credit for alternative fuel vehicles and expanding it to include bi-fuel natural gas vehicles.
- New vehicle retrofit credit: One comment suggests creating several new credits to encourage consumers to install combustion catalyst devices on their vehicles (resulting in better combustion and reduced emissions).
- Excise tax on liquefied natural gas (sec. 4041): Some comments suggest modifying the formula for taxing liquefied natural gas so that it is taxed on an energy equivalent basis with diesel fuel (rather than on a liquid gallon basis).
- Excise tax on heavy trucks (secs. 4051 and 4053): One comment suggests modifying the excise tax to exempt, in the case of alternative fuel vehicles, the excess cost of such vehicles over the cost of traditional trucks.
- Advanced energy project credit (sec. 48C): Some comments suggest authorizing the allocation of additional advanced energy project credits. One comment suggests clarifying the eligibility of projects that manufacture renewable chemicals and bio-based products.

Conservation and consumption

- Nonbusiness energy property credit (sec. 25C): Some comments suggest extending this credit, along with other renewable energy and energy efficiency provisions; others suggest it be repealed. One comment suggests modifying the credit to make it technology neutral. Others suggest modifying it to permit metal roofs with "cool roof" technology to qualify.
- Residential energy efficiency property credit (sec. 25D): Some comments suggest extending this credit, along with other renewable energy and energy efficiency provisions. Others suggest it be repealed. Some comments suggest modifying the credit so that high efficiency biomass thermal combustion property qualifies.

- Research credit (sec. 41): One comment calls for providing an enhanced research credit for researching technology that improves energy efficiency.
- New energy efficient home credit (sec. 45L): Some comments call for extending and modifying the credit. One comment suggests enacting a "whole house" energy efficiency credit for retrofits.
- Energy efficient appliance credit (sec. 45M): Some comments call for extending this credit. One calls for reforming the credit to make it performance-based and technology neutral.
- Qualified transportation fringe (sec. 132): One comment suggests permanent parity between transit benefits and parking benefits.
- Accelerated cost recovery (sec. 168): Some comments suggest shortening the recovery period to five years for certain energy efficient property and smart grids.
- Energy efficient commercial buildings deduction (sec. 179D): A number of comments suggest extending, making permanent, and/or reforming section 179D. Reform proposals include (1) measuring efficiency improvements relative to a building's pre-upgrade energy consumption (rather than an industry standard level of efficiency); (2) increasing the deduction amount to at least $3.00 per square foot; (3) scaling the deduction based on the energy savings achieved; (4) extending the benefits of the deduction to Indian tribes and tax-exempt organizations by allowing them to transfer those benefits; and (5) removing the limitations on S corporations claiming the deduction.

International competitiveness and financing

- Foreign tax credit rules for dual capacity taxpayers (sec. 901): Some comments suggest keeping the present-law dual capacity rules. One comment suggests that a territorial system of international taxation would be acceptable tax reform and would eliminate the dual capacity taxpayer issue. One comment calls for reforming the dual capacity rules to require that the creditable foreign taxes available to oil and gas companies not exceed the foreign tax that would have been imposed on such companies had they not been dual capacity taxpayers.

Other comments

- Grants: Some submissions recommended renewal of the grant-in-lieu-of-credit program (a.k.a. the 1603 grant program) and making grants under the Clean Coal Power Initiative exempt from tax.
- Activities on Indian lands: Some comments suggest a number of energy tax policy changes affecting Indian lands, including: (1) affirming the exclusive authority of Indian tribes to tax energy activities on Indian lands; (2) granting a permanent extension of the Indian coal production credit; (3) granting Indian tribes the authority to assign their share of the PTC generated on Indian lands; and (4) creating a new low sulfur diesel credit for tribal refineries.

F. Working Group on Financial Services

Comments on provisions relating to banks, thrifts, and credit unions

The public submissions received by the Working Group focus on issues relating to banks, thrifts, and credit unions. Those submissions suggest:

- Retaining tax-exempt status for credit unions;
- Refraining from imposing on regional banks any new regulatory restrictions relating to systemic financial risk;
- Repealing passthrough tax treatment for common trust funds.

Comments on provisions relating to insurance companies

The public submissions received by the Working Group focus on a variety of issues related to property and casualty insurance companies and life insurance companies. Those submissions suggest:

Health insurance fee

- Repealing the annual fee on health insurance providers;
- Repealing the annual fee on health insurance providers for stand-alone vision plans;

Property and casualty insurers

- Retaining and strengthening the property and casualty insurance company tax deduction for loss reserves that is based on annual statement accounting and reporting to State insurance regulators;
- Retaining present-law rules for property and casualty insurers permitting net operating loss carryforwards and carrybacks;
- Preserving rules permitting carryforwards of the alternative minimum tax credit if the alternative minimum tax is repealed;
- Maintaining the deductibility of interest expense of property and casualty insurers without any new limits;
- Grandfathering the tax treatment of existing tax-exempt bonds held by property and casualty insurers if a change is made in the tax-exempt bond rules;

Life insurers

- Rejecting proposals to further limit the dividends received deduction or reserve deduction of life insurance companies in connection with untaxed income of the company;

- Retaining the present-law section 501(c)(8) rules under which tax-exempt fraternal benefit societies sell insurance products such as life, annuity, and health insurance contracts;

Tax-free inside buildup

- Maintaining tax-free inside buildup for life insurance and annuity contracts;
- Repealing tax-free inside buildup for life insurance and annuity contracts;
- Taxing currently the investment income and gain on life insurance policies, while excluding actuarial gain;
- Retaining the present-law tax treatment of company-owned life insurance (COLI);

International insurance company issues

- Extending the present-law active financing exception and the controlled foreign corporation lookthrough exception to the Subpart F rules applicable to international insurance business;
- Rejecting proposals to increase taxes on reinsurance transactions with foreign affiliates.

Comments on provisions relating to equipment lessors

The public submissions received by the Working Group address issues relating to equipment lessors. Those submissions suggest:

- Treating depreciation deductions and interest deductions with respect to property that is owned by a lessor on the same footing as those deductions for such property that is owned by the operator of the property;
- Providing that net interest expense, whether from interest on a loan or from rental payments under a lease of equipment, should be treated the same under any tax reform proposal.

Comments on provisions relating to other financial services

The public submissions received by the Working Group focus on issues relating to other financial service providers. Those submissions suggest:

- Simplifying reporting of mutual fund distributions or providing a de minimis threshold below which individuals do not have to include or report such distributions.

Comments on the Ways and Means Discussion Draft on financial instruments

The Working Group received public submissions on the Ways and Means Discussion Draft on financial instruments. Those submissions suggest with respect to the Discussion Draft:

- That the definition of a derivative that is subject to mark to market treatment should be narrowed and further refined;
- That the mark to market proposal in its current form could affect routine investments of savers;
- That the mark to market proposal in its current form could affect transactions entered into in the ordinary course of business or investment such as acquiring put options, writing qualified covered call options, accepting debt plus warrants or convertible securities from startup or distressed businesses in exchange for capital, entering into options and forwards for the sale of real estate or businesses, taking short positions in stock or securities, securities lending, investing in mutual funds, and investing in exchange traded funds that hold derivatives;
- That requiring mutual funds to mark to market derivatives they hold could give rise to income without cash proceeds, making it difficult to meet the distribution requirement;
- That there could be discrepancies in the valuations of derivatives reported to taxpayers by market participants using differing valuation methods, and even pricing information required under Dodd-Frank clearing practices may be insufficient or inconsistent for this purpose, resulting in additional complexity in preparing tax returns and in a need for IRS guidance;
- That tax complexity could be increased by any lack of clarity under the discussion draft as to whether certain types of interests (*e.g.*, ADRs) are to be marked to market under the definition of a derivative, and as to whether arrangements economically equivalent to derivatives fall within the definition (*e.g.*, an interest in assets acquired as a hedge, which could be viewed as equivalent to a structured note; or two offsetting loans at fixed and floating rates respectively which could be viewed as equivalent to an interest rate swap);
- That the proposal should not apply an ambiguous standard such as substantial diminution of the taxpayer's risk of loss (used in the present-law straddle rules) to determine whether securities are marked to market;
- That a mark to market regime requires the payment of tax in the absence of any realization event that could give rise to cash to pay the tax;
- That a variety of investment vehicles could be discouraged under the proposal if it applies to them, such as stock loans and rehypothecation in brokerage accounts, structured notes, exchange traded notes, convertible debt instruments, exchange traded and over the counter long-term options, qualified covered call options, put options, short sales, derivative positions of mutal funds and exchange traded funds, access products that allow U.S. investors access to returns on some types of foreign securities, and possibly variable whole life and other insurance products;
- That some business arrangements and transactions used today could be affected by the proposal if it applies to them, such as business options and forward contracts, incentive compensation and deferred compensation, business straddles, and debt guarantees;

- That the provision in the discussion draft that relates to the issue price of debt in connection with debt modifications is helpful in permitting corporations to modify outstanding debt to take account of market changes, but there should be added a rule providing that holders who purchase the debt after its decline in value do not recognize gain solely because the issue price of the modified debt substantially exceeds its fair market value;
- That the provision in the discussion draft providing a limitation on the accrual of market discount on debt is needed, but the limit is too high and should be reconsidered;
- That the provision in the discussion draft to require current inclusion of market discount on debt exacerbates the present-law incentive to characterize market discount as attributable to gain in the event of the possible financial recovery of the debt issuer rather than to interest the issuer will earn once funds are advanced to the issuer, and the provision also results in a timing discrepancy in that gains from issuer survival are currently includable while losses from further deterioration of the issuer's financial condition would be deductible only when the debt becomes worthless;
- That the provision in the draft relating to average cost basis of securities may not be appropriate if blocks of stock are not economically fungible, and could add to computational, reporting, and compliance requirements;
- That the provisions could increase complexity and compliance costs for industries that rely on low cost of capital and that require liquidity;
- That a tax hedge which is not subject to mark to market treatment should be defined as a derivative position entered into by a taxpayer in its trade or business to manage its business or investment risks, including all risk management products to manage its business risks such as changes in interest rates, commodity prices, volume and revenue, weather risk, and currency;
- That for tax hedges not subject to mark to market treatment, character should be ordinary and gains and losses should be determined on a clear reflection of income basis for section 1221(a)(7) hedges and on an integrated basis for section 988(d) hedges;
- That contracts commonly entered into in the ordinary course of business in the natural gas and utility industries can be marked to market for financial accounting purposes and can qualify as tax hedges;
- That a derivative that is marked to market should be defined to exclude interests in trust, joint ventures, and MLPs;
- That the proposal permitting a taxpayers to meet the tax hedge identification requirement by relying on the hedge identification made for financial accounting purposes provides some relief from inadvertent failures but falls short of modernizing or expanding the hedging rules;
- That a legislative proposal to require marking to market should include transition rules and grandfather rules to alleviate potential character whipsaws;

- That the definition of embedded derivatives subject to mark to market requires additional clarification and needs transition relief.

G. Working Group on Income and Tax Distribution

The public submissions received by the Working Group on Income and Tax Distribution are varied in nature. In general, most of the comments do not explicitly address issues concerning income and tax distribution, and primarily express support for particular provisions of present law, or support broad fundamental tax reform involving elimination of tax expenditures in favor of lower rates or elimination of most current revenue sources in favor of a national retail sales tax. On occasion, fundamental tax reform or retention of particular provisions of present law were expressly supported because of their effects on income and tax distribution. Those comments, as well as others that addressed issues of income and tax distribution, are summarized below.

Comments on income and tax distribution

Submissions suggest:

- Preserving the Work Opportunity Tax Credit on the grounds that it helps the employment and income prospects of low income and other disadvantaged workers;
- Carefully considering the interests of low income taxpayers in any tax reform;
- Retaining the Earned Income Credit ("EIC") and Child Credit, particularly the refundable aspects of the child credit, for their benefits in helping low income families achieve financial stability; requiring the Committee of Ways and Means to study whether the EIC encourages fraud, discourages work;
- Retaining and expanding the income exclusion for public transit benefits on the grounds that it is particularly important to low and moderate income workers;
- Reforming the mortgage interest deduction to reduce the tax expenditure for upper income taxpayers, with revenues directed to affordable housing;
- Revising the rate structure: often these submissions promoted lower rates and fewer brackets without an explicit endorsement of reduced progressivity, though it was also argued that Congress should reduce progressivity in order to spur economic growth and raise living standards for all. Some commenters called for a more progressive tax code in general, while others endorsed having more rate brackets in order to have greater tax progressivity;
- Raising the maximum capital gains tax rate to 28 percent in order to improve progressivity, along with converting the standard and itemized deductions into a standard credit, replacing the dependent exemption with an expanded child credit, maintaining a progressive rate structure, and extending the enhanced earned income credit;
- Expanding tax benefits related to saving for low and moderate income taxpayers;
- Imposing a limit on itemized deductions and exclusions as proposed in the President's 2014 budget or similar proposals;

- Avoiding changes that would bring into the tax system persons not currently required to file;
- Preserving the low-income housing tax credit;
- Adopting a value added tax as a means to collect revenue from persons currently not paying positive income tax; and
- Reducing the marriage penalty, through use of a single rate table and separate filing of husbands and wives when both work, or through other means.

H. Working Group on International

The following comments were submitted to the Ways and Means Committee Tax Reform Working Group on International (hereinafter referred to as the "Working Group"). The summaries have been divided into several groups, loosely based on whether the submission addressed fundamental reform of the present system and how detailed the commentary around a particular issue was, regardless of whether it pertained to a proposal for comprehensive reform. Fundamental reform commentary is collected in the first two groups below: "Adoption of dividend exemption or similar source-based tax system" and "Expansion of worldwide tax system." Additionally, the Working Group received several detailed comments regarding the taxation of U.S. citizens residing abroad. These comments are summarized in the third section below. All other comments are included in the fourth and final section below.

1. Adoption of dividend exemption or similar source-based tax system

The Working Group received many comments generally supportive of a move away from the present worldwide system toward a dividend exemption system or more territorial, source-based system. Many of the comments specifically address provisions included in the reform proposal detailed in Chairman Camp's discussion draft.[1623]

General comments

Comments related to adoption of a more territorial system, including participation or dividend exemption systems, include the following recommendations:

- Adoption of any new international tax system should include transition rules that provide adequate time for implementation and that take into account prior reliance on the current tax code as manifested in existing agreements and practices;
- Provide a dividend exemption of no less than 95 percent;
- A territorial system should exempt active banking or financing profits by retaining and making permanent the exception from treatment as subpart F income for certain income derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business ("active financing income");
- Include a "look-through rule" that permits exclusion from income of all dividends, interest, rents, and royalties received by one controlled foreign corporation ("CFC") from a related CFC to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as effectively connected income ("ECI");

[1623] Chairman Camp's discussion draft, released October 26, 2011, is available on the Ways and Means website, at http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf.

- Any transitional charge upon moving to a new regime should permit netting of profitable and loss subsidiaries in determining the aggregate earnings and profits that may be subject to a toll charge;
- In computing any transitional charge upon moving to a source-based or territorial regime, capital requirements under the law of local jurisdictions must be considered for banking and insurance businesses;
- Any reform of international tax provisions should be broad enough to include active passthrough entities, particularly S corporations, within its scope;
- If the move toward territorial is in the form of a dividend exemption system, S corporations should be eligible for the dividend exemption.

Comments specific to the Chairman's discussion draft

The Working Group received commentary regarding the specifics of the participation exemption system proposed in the Chairman's discussion draft. These comments address the structure of the exemption itself, the foreign tax credit ("FTC") provisions, the reform of subpart F, the various base erosion proposals, the thin capitalization provision, and the transition rules.

Comments about the structure of the Chairman's participation exemption include the following recommendations:

- Rather than rely upon an actual distribution to trigger recognition of a portion of foreign earnings and profits, consider inclusion of a fixed percentage of the gross income of CFCs in the year earned to reflect the deduction disallowance of expenses related to foreign exempt income;
- Increase the dividend exemption to 100 percent;
- Do not allow the exemption for any portion of earnings that would have been part of subpart F income were it not for the de minimis exception in section 954(b)(3)(A);
- The exemption should cover all active income and tax only passive, portfolio-type income;
- The exemption should be available to any 10-percent shareholder, including individual shareholders and passthrough entities;
- Branches should not be deemed separate corporations for all purposes of the Code. Some alternatives for branches include the following:
    - Retain the present law rules for foreign branch income, *i.e.*, treat branch income as not eligible for exemption. Under this alternative, branch income is taxable in the United States immediately, offset by FTCs;
    - Allow an election to retain present law rules for branches. Branches not electing to remain with the current system are subject to an exemption system that does not deem them to be CFC for all purposes of the Code. A 95-percent exemption applies to net foreign branch income, foreign branch losses are disallowed, FTCs attributable to exempt income are disallowed, and the branch computes subpart F

income as if it were a CFC. Under this alternative, appropriate rules are needed to address intra-company (branch to branch) transactions and to ensure the proper allocation and apportionment of more general expenses;

- Grandfather branches existing at the time of enactment under present law. Non-grandfathered branch income is treated as exempt to the same extent as dividend income;
- Allow an election to retain present law only for existing branches;
- Adopt an exemption system for branches that does not deem them to be CFCs for all purposes of the Code. Under this alternative, branches are treated under rules similar to the non-electing branches described above.

Comments about the foreign tax credit provisions included in the Chairman's draft include the following recommendations:

- Retain the rule against splitting foreign taxes from related income as in present-law section 909;
- Restore the indirectly allocable expenses to the calculation of the FTC limitation;
- Retain the present-law FTC baskets as in present law section 904(d);
- FTC baskets should be limited to, at most, active and passive baskets;
- FTC carryforwards from pre-effective date years should be available to offset tax on future non-exempt active foreign income;
- Repeal the FTC limitation for oil and gas income.

Comments about the Chairman's proposed reform of subpart F include the following recommendations:

- Retain the previously-taxed income ("PTI") concept;
- Retain the CFC look-through rule;
- Retain and ease the active financing exception of subpart F for financial services companies;
- Retain the same-country subpart F exception;
- Exempt income should include foreign base company sales and services income;
- Repeal the subpart F category of foreign base company oil-related income.

Comments related to the three alternative base erosion options in Chairman Camp's discussion draft are presented below:

- Option A:
  - Add a rebuttable presumption that intangibles within the meaning of section 936(h)(3)(B) have been used directly or indirectly in the relevant sales and services of the foreign base company;
  - Increase the minimum effective tax rate applicable to a fixed percentage of the maximum corporate rate, similar to the current high-tax kick-out rate in section 954;
  - Eliminate the phase-out aspect of the effective tax rate calculation.
- Option B:
  - The new subpart F inclusion should not apply where the country of incorporation is different from the country of operation;
  - The exception should not be limited to manufacturing in a country for domestic use; export centers should be recognized;
  - Set a higher effective tax rate than that proposed;
  - Others recommended that option B not be included.
- Option C:
  - Reject the proposal due to concerns about administrability of a proposal dependent on proper identification and valuation of intangible property;
  - Provide clear definitions of intangible income and foreign intangible income;
  - Adopt a formulary measure of a foreign subsidiary's active business earnings to simplify the determination of foreign intangible income;
  - Revise to ensure that Option C cannot be construed as an export subsidy or other violation of U.S. trade commitments under World Trade Organization ("WTO") obligations;
  - Extend the incentive rate to all sales of domestically manufactured goods, rather than only export sales.

Suggestions related to the thin capitalization provision in Chairman Camp's discussion draft are presented below:

- Apply present law section 163(j) rules, *i.e.*, if the debt-to-equity ratio exceeds 1.5 to 1, net interest is deductible only to the extent of 50 percent of adjusted taxable income;
- Apply thin capitalization rules on a tax consolidation basis rather than on a separate company basis;
- Eliminate the worldwide relative leverage test;

- Eliminate the provision entirely.

Suggestions related to the transition provision in Chairman Camp's discussion draft are presented below:

- Treat cash or cash equivalents differently than accumulated earnings reinvested in plant and equipment;
- Allow accumulated losses of foreign subsidiaries to offset positive accumulated earnings.

2. Expansion of worldwide tax system

Several submissions recommend expanding the present law worldwide system of taxation or adoption of a worldwide full inclusion tax system under which U.S. corporations would be currently taxed on all foreign earnings.

Worldwide full-inclusion system

Submissions include a proposal favoring the taxation of U.S. corporations on their worldwide income, with no deferral of U.S. taxation of foreign income. The proposal includes the following recommendations:

- Repeal deferral permitted under present law subpart F;
- Define foreign earnings of a U.S. corporation to include all earnings of any foreign subsidiary entity, either by revision or repeal of subpart F and passive foreign investment companies rules, or adoption of some other mechanism to ensure full inclusion;
- Retention of FTC to prevent double taxation, with tightened limitations such as country-by-country tracking;
- Inclusion of anti-base erosion measures such as adoption of a management and control standard for residency and strengthening the rules to prevent corporations from engaging in inversion transactions or aggressive transfer-pricing;
- Reconsider the definition of U.S. residency for cross-border joint ventures that U.S. persons may establish for new ventures.

Other recommendations for expansion of worldwide taxation

- Restrict deductions associated with moving operations abroad and provide a tax credit for moving operations to the United States;
- Limit the deduction for interest expense related to foreign operations;
- Impose higher levels of taxation on income associated with intangible property that is shifted overseas;
- Revise and tighten transfer pricing rules to prevent shifting of highly mobile income.

3. U.S. citizens residing abroad

Numerous comments were received that relate to the taxation of U.S. citizens living abroad. These comments include the following recommendations:

- Repeal or revise the Foreign Account Tax Compliance Act ("FATCA");
- Provide an unlimited foreign-earned income exclusion for permanent residents of a foreign country;
- Expand the foreign-earned income exclusion to include passive as well as earned income;
- Repeal the special rules on passive foreign investment companies;
- Repeal the provisions imposing tax responsibilities on those who expatriate by relinquishing U.S. citizenship or residency, including the ban on issuance of visas to expatriates who avoid payment of taxes;
- Adoption of residence-based taxation (see below);
- Residence-based taxation should not include a provision for imposing 30 percent withholding tax on U.S.-source pensions;
- Any move to residence-based taxation implies the need to eliminate the savings clause from new and existing tax treaties;
- Creation of a bipartisan commission responsible for studying the impact of Federal laws and policies on U.S. citizens living abroad, especially those provisions and administrative programs that require disclosure of financial information. The Commission would report to Congress with recommendations and submit a follow-up report on any remedial administrative response to the report.

The Working Group also received technical comments related to the computation of income tax when a portion of income is excluded under the foreign-earned income exclusion.

<u>Adoption of residence-based taxation</u>

Many comments proposed adopting a residence-based tax system to treat certain U.S. citizens domiciled abroad in the same manner as foreign persons, applying withholding taxes to U.S.-source income earned by such U.S. citizens and taxing effectively connected income as under the present law rules. The proponents of a residence-based tax system suggest the following elements:

- U.S. citizens that meet certain requirements could continue to be taxed under the rules of present law or could elect into residence-based taxation;
- U.S. citizens electing residence-based taxation are subject to a departure tax based on the unrealized capital gains on the value of assets on the date of departure;

- Departure tax is due only if certain thresholds of assets or income tax paid in recent years are met, and will not apply to U.S. real property, primary residence abroad, and retirement plans or pension funds;
- U.S. citizens who are compliant in the U.S. tax filings and have established residence abroad two years or more before the effective date of the proposal are exempt from the departure tax;
- U.S. citizens electing residence-based taxation are subject to the estate tax rules applicable to non-resident, non-citizens (*i.e.*, U.S. assets, including real estate, securities, trusts, and partnerships in excess of $60,000 are subject to estate tax);
- The $60,000 estate tax exemption equivalent amount for estates of non-resident non-citizens should be increased;
- Implement a streamlined offshore voluntary disclosure initiative with no restrictions on eligibility:
  - The proposed voluntary disclosure initiative is not under the administrative purview of the IRS criminal division;
  - The proposed initiative (1) requires three years of back tax reporting, (2) eliminates the requirement to file the FBAR, (3) eliminates all non-filing penalties for FBAR and Form 8938, (4) eliminates any threat or risk of criminal prosecution, (5) is open to all non-residents, with no ceiling threshold for the amount of taxes due, and (6) is limited to payment of back taxes, interest and late filing penalties related to unpaid taxes associated with the three-year back-filing requirement.

4. Other

The Working Group received comments on other aspects of international taxation. These comments vary in topic and the suggestions are detailed below:

- Implement a gross margin tax on business operations with an employment equalization credit:
  - The tax applies to the global revenues of affiliates and foreign businesses as a single unit;
  - Deductions are allowed for cost of goods sold, employee salaries, and employee benefits;
  - Gross margin tax liability is apportioned to the United States revenue based on U.S. sales versus foreign sales;
  - The gross margin tax is applied to any business that operates in the United States whether headquarter in the United States or in a foreign country.
- Adopt a limited exemption from section 956 for loans made by a CFC to the U.S. shareholder (corporate and non-corporate):

- The exemption is available for a limited time after enactment and applies for loans with a loan term of eight to ten years;
- The use of proceeds could be targeted for specified domestic investment and capital formation activities, including funding for research and development, expansion of facilities, early stage venture capital investment, manufacturing start-up costs, real estate investments, and U.S. energy and technology investments.

- Preserve the present law exception from foreign base company sales income for related party sales of agricultural commodities (including, under Treasury regulations, coffee beans and cocoa) that are not grown in the United States in commercially marketable quantities;
- Respect the Cayman Island's sovereignty and do not associate the Cayman Islands with tax evasion;
- Eliminate the "check-the-box" regulations, which provide taxpayers an elective method to determine the classification of an eligible entity as either a corporation, partnership, or disregarded as an entity separate from its owner;
- Do not adopt the President's FY 2014 Budget proposal to alter the dual capacity taxpayer rules;
- Retain and make permanent the active financing exception;
- Retain and make permanent the CFC look-through rule;
- Expand the subpart F active royalty exception to include royalties from related parties;
- Retain direct FTCs;
- Reduce the United States statutory corporate tax rate to align with those of our major trading partners;
- Eliminate restrictions on expenses allocable to deferred or exempt income;
- Adopt a patent or innovation box regime that would provide reduced rates of tax for income earned from intellectual property, including royalties paid by foreign corporations to U.S. corporations for rights to use intangible property outside the United States;
- Any limitation on the deductibility of interest expense allocated to foreign income should, among other things, apply to net, not gross, interest expense;
- Repeal section 163(j);
- Eliminate industry specific tax restrictions including the special foreign tax limitation applicable to foreign oil and gas income;
- Allow subchapter S corporations to use indirect FTCs (section 902 credits) on the same basis as C corporations;
- Subject foreign-flagged passenger cruise lines to U.S. Federal income tax;

- Retain the tonnage tax regime applicable to U.S-flagged shipping companies;
- Do not adopt proposals to limit or effectively prohibit the tax deduction for the purchase of affiliate reinsurance by foreign-owned U.S. insurers. If any abuse related to affiliate reinsurance income exists, some suggest placing sensible parameters on the amount of affiliate reinsurance that allow for legitimate business uses;
- Adopt a statutory safe harbor permitting deductibility of reinsurance premiums when ceded from a U.S.-based company to a related foreign reinsurer. Parameters of the safe harbor include whether inappropriate tax incentives in the home country of the foreign reinsurer exist, and whether a differential treatment exists between reinsurance services provided by any other WTO member and those provided by U.S. reinsurers;
- Repeal the tax deduction for the purchase of affiliate reinsurance by foreign-owned insurers;
- Encourage trade representatives and trading partners to allow income taxes to be border adjusted;
- Collect U.S. income and payroll tax on visiting executive's wages earned in the United States by requiring Transportation Security Administration ("TSA") agents to collect sailing permits;
- Repeal the sailing permit requirement for collection of U.S. income and payroll tax on visitors' wages earned in the United States.

I. Working Group on Manufacturing

The following comments were submitted to the Ways and Means Committee Tax Reform Working Group on Manufacturing (hereinafter referred to as the "Working Group").

2. Research and Development

Many comments received by the Working Group relate to the R&D credit. Specifically, the submissions contend that the R&D credit should be:

- Retained and made permanent;
- Increased to provide a larger benefit, including a more generous benefit if the research is undertaken for a specific purpose (*e.g.*, improving energy efficiency) or if manufacturing incorporating the research is performed in the United States;
- With respect to the alternative simplified credit, increased to 20 percent;
- Expanded to apply to a larger category of expenditures, including all expenses below the base amount (thereby eliminating the incremental aspects of the credit);
- Revised to allow the credit to benefit taxpayers in loss positions;
- Amended to permit taxpayers to claim the credit against the alternative minimum tax;
- Modified to be more administrable for taxpayers and the IRS while also reducing or eliminating controversy;
- Repealed because: (1) the current incremental structure is not effective, (2) the credit is not available for many associated costs, and (3) the temporary nature does not result in incentivizing behavior.

Alternatively, some suggest that a significant reduction in the corporate rate eliminates the need for the R&D credit.

Retaining present-law treatment which permits a current deduction for research and development costs also was recommended.

3. Capital Expenditures

Submissions to the Working Group relating to capital expenditures vary; the following details those comments:

- Many comments urge Congress to retain accelerated depreciation, and allow for depreciation lives to be updated for new technology.
- Other comments recommend revising the depreciation rules to more closely align with economic depreciation.
- Further comments suggest requiring capitalization for items such as software development, product design, patent costs, and films.

- Some remarks relate specifically to individual cost recovery provisions, such as --
  - Maintaining present-law rules for the depreciation of aircraft, including five-year depreciation for corporate jets;
  - Maintaining present-law rules for the depreciation of property on Indian reservations;
  - Continuing present-law treatment for timber which, among other things, allows for the immediate expensing of forest management costs[1624] and up to $10,000 of reforestation costs;[1625]
  - Reenacting, and making permanent, five-year depreciation for agricultural equipment;
  - Shortening the recovery period for certain building components to 15 years from 39 years;
  - Repealing the preferential treatment for capital construction funds; and
  - Making permanent the railroad track maintenance credit.[1626]
  - Maintaining present-law rules for depletion;
  - Maintaining present-law treatment for intangible drilling costs ("IDCs");
  - Repealing depletion and expensing of IDCs;
- A number of submissions discuss bonus depreciation --
  - Some encourage Congress to consider renewing, or making permanent, bonus depreciation;
  - A few also suggest revising the bonus rules to take into account the impact on long-term accounting[1627] and section 199;
  - Others recommend enacting bonus depreciation only on a prospective basis and only for short periods of time to stimulate a depressed economy.
- Comments submitted to the Working Group also encourage Congress to enact permanent rules for immediate expensing. In particular, some comments --
  - Recommend that current ($250,000 and $800,000) or increased ($500,000 and $2 million) section 179 levels be made permanent;
  - Propose immediate expensing of all equipment purchases.

[1624] See sections 162 and 263A(c)(5).

[1625] See section 194.

[1626] See section 45G.

[1627] See, *e.g.*, section 460(c)(6).

- Submissions also recommend Congress consider revising the rules related to casualty and businesses losses when a taxpayer retains an asset.

4. Assets Purchased or Produced by the Taxpayer

Domestic Production Deduction[1628]

A number of submissions encourage Congress to maintain present-law section 199, including for all current recipients (*e.g.*, architects, oil and gas companies). Additional comments discuss:

- Revising the rules under section 199 to allow taxpayers in loss positions to benefit from the deduction;
- Modifying or eliminating the wage limit to allow sole proprietors and those who pay little or no wages to claim the deduction for income related to their domestic production; and
- The need to simplify various aspects of the section 199 calculation.

Conversely, the Working Group received comments supporting the repeal of section 199 including for the following reasons:

- The deduction is not sufficient to justify the compliance burden associated with performing the calculation; and
- A significant reduction in the corporate rate would eliminate the need for section 199.

Inventory

A number of comments relate to accounting for inventory. In particular, submissions urge Congress to --

- Resist repealing the ability for businesses to use a last-in, first-out ("LIFO") method;
- Consider retaining LIFO for tax purposes even if no longer permitted for financial statement purposes (*e.g.*, adoption of International Financial Reporting Standards ("IFRS"));
- Repeal businesses' ability to use a LIFO method;
- Maintain present-law rules allowing inventory to be valued using the lower of cost or market ("LCM") method; and
- Repeal or simplify section 263A (also known as the UNICAP rules).

[1628] Section 199 often is referred to as the domestic production deduction.

Long Term Contract Accounting

The Working Group received suggestions related to the exception from section 460 for certain construction contracts. In particular, the proposals recommend increasing the gross receipts limit from present-law $10 million to $40 million.

5. Other Topics

Certain suggestions made by contributors that did not fit neatly into any of the above categories are detailed below.

- Many comments urge Congress to preserve present-law treatment for items such as --
  - The business deduction for interest expenses;
  - The ability to carryback and carryforward net operating losses;
  - The ability to take into account prior minimum tax credits;
  - The treatment of contributions in aid of construction;[1629]
  - The deductibility of employee health care costs and pension contributions.
- Some remarks discuss the need to maintain or expand current rules allowing for passthrough treatment for certain publicly traded partnerships (often referred to as "Master Limited Partnerships")
- To the extent significant changes are made to the rules affecting a company's deferred taxes, commentators advocate for appropriate transition rules, including normalization.[1630]
- Some commentators call for the repeal of the alternative minimum tax.
- A number of submissions encourage Congress to consider enacting an "innovation (or patent) box" whereby income associated with qualifying intellectual property would be taxed at a lower, preferential rate. Others caution that the complexities of an innovation/patent box may outweigh any potential benefits.
- A few comments propose the establishment of a "manufacturing reinvestment account" which would allow a deduction for amounts contributed to a qualifying account and to be expended in their manufacturing business.
- Commentators also propose new tax incentives, including --
  - an R&D credit that may be claimed against employer-side payroll taxes;
  - accelerated depreciation for installing insulation above the minimum standards;
  - a non-refundable tax credit for the purchase of a hearing aid;

[1629] See section 118.

[1630] See, *e.g.*, section 168(i)(9).

- a tax credit for the consumer related to products manufactured in the United States by a designated group of "disruptive technologies;"[1631]
- allowing start-up businesses to expense 25 percent of costs incurred in constructing their first domestic manufacturing facility;
- a tax credit for qualified clinical testing expenses related to qualified infectious diseases;
- giving businesses that meet certain "patriotic standards"[1632] a five-percent reduction in taxable income and a preference in obtaining government contracts.

Additional submissions recommend a number of additional credits and accelerated deductions that could be made available to employers or employees in the manufacturing sector. However, sufficient details of the proposals were not provided.

6. Tax Reform for Manufacturing Businesses

Comprehensive tax reform

The majority of comments received by the Working Group urge Congress to consider undertaking comprehensive tax reform. The submissions suggest that:

- Tax reform must take into account tax rates and expenditures for corporations as well as businesses taxed at the individual level (*e.g.*, passthrough entities, sole proprietorships).
- Making tax provisions permanent would allow businesses to effectively plan for the future and promote growth.
- Simplifying the tax code and reducing the administrative burden associated with compliance should be a goal of tax reform.
- Any tax reform should be revenue-neutral.
- Congress should consider instances where financial statement information can be leveraged and used for tax purposes (also known as book-tax conformity).
- Changing to, or adding, a value-added tax ("VAT") should be contemplated.

[1631] Disruptive technologies are defined as those technologies that create new markets and displace earlier technologies.

[1632] Companies that voluntarily meet the following "patriotic standards" include those that: (1) produce at least 90 percent of their goods and services in the United States; (2) spend at least 50 percent of their research and development budgets in the United States; (3) limit top management compensation to no greater than 100 times that of their lowest-compensated full-time workers; (4) contribute at least five percent of payroll to a portable pension fund; (5) pay at least 70 percent of the cost of health insurance premiums; (6) maintain neutrality in employee organizing drives; (7) provide full differential salary and insurance benefits for all National Guard and Reserve employees who are called to active duty; and (8) comply with Federal regulations regarding the environment, workplace safety, consumer protections, and labor relations.

Reduction in corporate tax rate

Many comments to the Working Group support an overall reduction in the corporate tax rate. The submissions include discussions of:

- The need for a significant reduction in the corporate tax rate to remain competitive with foreign multinationals;
- A desire to reduce the corporate tax rate to 25 percent;
- The willingness to forgo tax benefits such as section 199, accelerated depreciation, and the research and development tax credit ("R&D credit") in exchange for a 25 percent corporate tax rate.

However, some comments observe that reducing the corporate rate would not make up for repealing certain current provisions (*e.g.*, intangible drilling costs).

J. Working Group on Pensions/Retirement

1. In general

Various submissions expressed support for present-law tax expenditures for retirement savings, including life insurance and annuity contracts, and opposed proposals that would reduce the benefits provided by present law. Various comments also included proposals to expand or improve the effectiveness of present-law tax expenditures, whereas some comments offered proposals to reduce or eliminate certain aspects of present-law tax expenditures.

2. Individual saving; small employer incentives; additional plan designs

Comments suggested:

- Increased use of automatic enrollment, including (1) implement automatic payroll deduction IRAs, either as voluntary or as mandatory on the part of employers, and (2) provide incentives to use higher default contribution rates and automatic increases in default contribution rates ("automatic escalation");
- Changes to the limits on retirement savings, including (1) repeal present-law income-based limitations on IRA contributions, (2) increase the limit on catch-up contributions, (3) eliminate all present-law limits on contributions to all types of retirement plans, (4) limit retirement plan contributions, for example, limit contributions to the amount needed on an actuarial basis to provide $50,000 of annual income in retirement, (5) replace elective deferrals with a "reverse match," for example, an employee could contribute $1 for each $2 contributed by employer;
- Replacement of all tax-favored savings vehicles (*e.g.*, retirement, education, health) with a single type, contributions to which are deductible (subject to a limit) and distributions from which are taxed as ordinary income, with distributions required to begin at age 70½;
- Expansion of the saver's credit, including (1) make the credit refundable, (2) modify the current phase-out, for example, by expanding the income limits and eliminating the cliffs in the current credit structure, (3) provide the credit as a match (*e.g.*, $1 for every $2 of individual contributions) that is required to be contributed to a retirement account and not available for distribution until retirement, (4) provide the credit as a contribution to an account that can be used for short-term emergency needs rather than just a retirement account, (5) enable individuals to open and make contributions to tax-favored accounts through the filing of their income tax returns and provide a dollar-for-dollar match of up to $500 for low- and middle-income individuals;
- Expansion of the tax credit for a small business that establishes a retirement plan, including making it refundable;
- Creation of a government bond specifically for retirement saving that can be used as a safe and simple investment vehicle by individuals and by small employers wanting to establish a plan;

- Incentives for small employers to adopt a plan under which employer contributions are determined by the amount estimated to provide a specified level of annuity benefit at retirement, with the option of employee contributions to provide additional benefits, and with the amount of actual retirement benefits based on plan assets;
- Creation of a safe harbor for multiple-employer plans that protects the plan sponsor and adopting employers from adverse consequences of actions by noncompliant adopting employers;
- Creation of a new type of plan, under which employer and employee contributions are pooled and assets centrally managed, with benefits paid only at retirement (or after death) and in lifetime income form.
- Creation of a universal retirement system that applies to all workers (including part-time, temporary, and other workers who change jobs frequently) with automatic payroll deductions by employers, a single portable account for each worker, a flat refundable tax credit for all workers of 30 percent of savings, and government matching contributions for the initial savings of lower- and middle- income workers.
- Creation of an Office of Participant Advocate within the IRS to represent the concerns of retirement plan participants and beneficiaries.

3. Distributions and rollovers

Comments suggested:

- With respect to hardship distributions, (1) allowance of hardship distributions for all amounts subject to in-service distribution restrictions, rather than just elective deferral amounts, (2) elimination of requirement that a participant first take available plan loans before taking a hardship distribution, and (3) elimination of the prohibition on elective deferrals for six months after a hardship distribution;
- With respect to rollovers, (1) extension of the rollover period for a distribution resulting from offset of a participant's account by a plan loan balance after termination of employment, (2) ability of a terminating section 403(b) plan to distribute to participants custodial accounts and annuities containing account balances, with continued tax-favored treatment, (3) treatment of a life insurance contract distributed from an employer-sponsored plan as a permitted rollover contribution to an IRA, (4) ability to roll over to another retirement plan or IRA a guaranteed lifetime income product that is no longer offered under a retirement plan, (5) ability to roll over a distribution from a Roth IRA to a designated Roth account under an employer-sponsored plan, and (6) ability of a nonspousal beneficiary to roll over a benefit under the decedent's employer-sponsored plan to the plan of the beneficiary's own employer (rather than only to an IRA);
- With respect to leakage (that is, drawing on retirement savings before retirement), creation of a voluntarily designated account that cannot be accessed before retirement, with targeted incentives for employees and employers to use such accounts;

- With respect to phased retirement (that is, partial retirement distributions in conjunction with a reduced work schedule as a transition to full retirement), (1) retention of the discretionary nature of phased retirement arrangements without restrictions or complicated testing, (2) treatment of access to pension benefits during phased retirement as a feature that is not subject to anti-cutback protection, and (3) option, but not requirement, to offer health benefits to employees during phased retirement;
- With respect to lifetime income, (1) require that information be provided to participants in defined contribution plans about the value of lifetime income and the equivalent annuity or lifetime income amounts that the participant's account balance could provide, (2) incentives to offer annuity and partial annuity distribution options, including annuities that start at later ages, and (3) incentives for participants to structure their retirement distributions to protect against longevity risk;
- With respect to the tax treatment of distributions, (1) allowance of capital gains treatment of retirement plan distributions, (2) allowance of tax-free IRA distributions to charity (up to $100,000 annual limit) at age 65 or later on a permanent basis, and (3) repeal of the exclusion for net unrealized appreciation on distributions of employer securities.
- Elimination of the minimum distribution requirements or revisions to reduce or delay required distributions by (1) increasing the age for commencement of required distributions from 70½ to 75, (2) allowing five-percent owners who continue working after age 70½ to delay commencement of distributions until retirement, (3) excluding from the requirements assets invested in longevity insurance, accounts under which at least 50 percent of the account is annuitized starting no later than social security retirement age (subject to a limit of $1 million on the remainder of the account), and assets in a designated Roth account under an employer-sponsored plan, and (4) allowing required distributions to be converted on an after-tax basis to a Roth IRA or designated Roth account in a plan (that is, allow a Roth conversion for these amounts rather than distribution);
- Revision of the minimum distribution requirements to increase or accelerate required distributions by (1) reducing the age for commencement of required distributions from 70½ to an earlier age, such as 65, (2) accelerating the rate of withdrawals, such as beginning at five percent of the account balance and then redetermining the required rate for future years, and (3) shortening the period over which required distributions must be made after death.

4. Roth arrangements

Comments suggested:

- Consolidation of multiple types of IRA under present law into a single type to which an individual could contribute $7,500 annually on an after-tax basis, with distributions after age 58 excluded from income (in effect, repeal of traditional IRAs and retention of only Roth-type IRAs);

- Repeal of Roth treatment for future IRA contributions and future elective deferrals to employer-sponsored plans, as well as elimination of Roth conversions (in effect, retention of only traditional IRAs and pretax elective deferrals under employer-sponsored plans);
- Application of the lifetime minimum distribution requirements to Roth accounts, or, alternatively, requiring existing Roth balances to be distributed over the shorter of life expectancy or 25 years;
- Disallowance of an individual's interest deductions up to the value of the individual's Roth accounts;
- Expansion of Roth conversions to all pretax retirement savings (or pretax savings up to a limit), with the resulting income subject to tax at a flat rate of 10-15 percent, and allowing individuals age 59½ or older to take excludible distributions immediately.

5. ESOPs

Comments suggested:

- Extension of nonrecognition of gain on the sale of S corporation stock to an ESOP, taxation of an ESOP's share of S corporation income, and repeal of provisions relating to S corporation ESOPs;
- Repeal of employer deduction for dividends on C corporation stock held by an ESOP, and repeal of nonrecognition of gain on sale of C corporation stock to an ESOP;
- Repeal of prohibited transaction exemptions relating to ESOPs.

6. Defined benefit plan funding

Comments suggested:

- With respect to single-employer plans, (1) increase in deduction limits to allow greater prefunding of liabilities, (2) treatment of pension liabilities as long-term liabilities over 20-30 years, and (3) elimination of the excise tax on reversion of plan assets after all benefits have been paid to participants;
- With respect to multiple-employer plans, funding rules that better accommodate multiple-employer plans, including multiple-employer plans maintained by charities;
- With respect to multiemployer plans, (1) extension of the funding rules under the Pension Protection Act of 2006, (2) elective critical status for certain multiemployer plans, (3) clarification of the interaction of the tests for critical status and emergence from critical status, (4) coordination of restrictions for plans in endangered and critical status, (5) disregard of certain contribution increases in determining withdrawal liability and limitations on withdrawal liability, and (6) automatic extensions of amortization and asset value "smoothing" periods in the case of significant market declines.

7. Governmental plans and church plans

Comments suggested:

- With respect to State and local governments, elimination of the requirement that deferral elections (and changes to elections) under a governmental section 457(b) plan must be made before the beginning of the month;
- With respect to Indian tribal governments, (1) extension to Indian tribal governments of the same treatment that applies to State and local governments, (2) elimination of restrictions on governmental plan treatment for plans of Indian tribal governments, including restrictions relating to essential government functions and commercial activities, or limiting the restrictions to activities engaged in for private rather than public interests, (3) extension of special distribution rules for public safety employees of State and local governments to public safety employees of Indian tribal governments, (4) extension to domestic relations orders issued by Indian tribal courts of the same treatment that applies to domestic relations orders issued by State and local government courts, (5) treatment of certain preexisting Indian tribal government plans as established by a State or local government for purposes of rules relating to eligible deferred compensation plans, and (6) extension of treatment as an "exempt governmental deferred compensation plan" for Social Security and Medicare tax purposes to deferred compensation plans of Indian tribal governments.
- With respect to church plans, (1) modification of the controlled group rules so that multiple church-affiliated entities are not required to be aggregated, (2) application of only the limit on benefits under a defined benefit plan (and not the limit on contributions to defined contribution plans) to defined benefit section 403(b) plans, (3) Federal preemption of State wage laws that may impede the use of automatic enrollment by church plans, (4) expansion of permitted transfers and mergers between section 403(b) plans and qualified retirement plans, and (5) expansion of rules allowing retirement plan assets to be held in a group trust so that a church's own assets (not just church plan assets) can also be held in the group trust.

8. Nondiscrimination rules

With respect to section 401(k) plans, comments suggested:

- Revision of safe harbor rules, including (1) under the automatic enrollment safe harbor, a required matching rate of only 50 percent on contributions up to 6 percent of compensation and removal of the 10-percent limit on default rates, (2) ability to use forfeitures for safe harbor matching or nonelective contributions, (3) elimination of the notice requirement for nonelective contributions and use of a one-time matching contribution notice (rather than required annual notices), (4) expanded ability to amend a safe harbor plan during the plan year, (5) ability to adopt a nonelective safe harbor contribution design up to the deadline for distributing excess deferrals if a four-percent (rather than three-percent) safe harbor rate is used, (6) creation of a new safe harbor under which only elective deferrals are permitted, deferrals are limited to $8,000 (plus up to $2,000 catch-ups), and eligible employees are automatically

enrolled at a minimum default rate of at least three percent of compensation, and (7) ability to replace a SIMPLE plan with a safe harbor plan during a calendar year;

- Creation of a new test that is met if either the average deferral rate for nonhighly compensated employees exceeds six percent, or the average deferral rate for highly compensated employees is less than 200 percent of the average deferral rate for nonhighly compensated employees.

With respect to other nondiscrimination testing issues, comments suggested:

- Creation of a simplified safe harbor definition of compensation for nondiscrimination purposes;
- Treatment of a defined benefit plan that is closed to new employees and that meets certain criteria (that is, it satisfied nondiscrimination tests immediately before coverage was closed and is not otherwise amended to change the covered group or benefit formula) as (1) continuing to cover a nondiscriminatory group and (2) continuing to be eligible for the method of testing previously used, such as by aggregation with a defined contribution plan;
- Treatment of allocations for nonhighly compensated employees under a defined contribution plan (or accruals for nonhighly compensated employees under a defined benefit plan closed to new employees) as accruals for purposes of applying the minimum participation requirements to a defined benefit plan that is aggregated with the other plan for nondiscrimination purposes;
- For purposes of the minimum participation requirements, (1) exemption for a defined benefit plan if allocations under a defined contribution plan of at least 7.5 percent of compensation are provided to a sufficient number of nonhighly compensated employees and the two plans are aggregated for nondiscrimination purposes, (2) exemption for a frozen defined benefit plan if the employer maintains no other defined benefit plan, and (3) permissive aggregation of a frozen defined benefit plan with another defined benefit plan or a defined contribution plan, but taking into account only accruals or allocations under the other plan for nonhighly compensated employees.

With respect to the top-heavy requirements, comments suggested:

- Elimination of the top-heavy rules generally or for defined contribution plans;
- For small employers, separate application to employees with less than 1,000 hours of service for the year;
- Elimination of top-heavy contribution requirements for nonkey employees with less than a year of service who are permitted to make elective deferrals;
- Disregard of elective deferrals made by key employees;
- Use of the plan's definition of compensation to calculate top-heavy minimum allocations.

9. Plan administration

Comments suggested reducing the burdens involved in plan administration, including:

- Extension of the time for adoption of a new plan up to the due date (including extensions) for filing of the employer's tax return for the taxable year in which the first plan year ends;
- Allowance of at least three years in which to make plan amendments to reflect changes in law (regulatory and statutory), or, if later, until the next required restatement of the plan or the next required submission for a determination letter, with related relief from the anti-cutback rules, provided the plan amendment reflects plan operation during this period;
- Reduction in required notices and elimination of notices that duplicate information included in the summary plan description, such as information on safe harbor contributions to a section 401(k) plan or the right to a qualified preretirement survivor annuity, as well as expansion and consistency in the ability to use electronic delivery;
- With respect to spousal protections, (1) allowance of a waiver (with spousal consent) of a qualified preretirement survivor annuity at any age, and (2) allowance of a plan sponsor to transfer responsibility for providing and administering annuity options to an annuity provider.

10. Life insurance and annuity contracts

Comments suggested:

- Maintaining tax-free inside buildup for life insurance and annuity contracts;
- Repealing tax-free inside buildup for life insurance and annuity contracts;
- Taxing currently the investment income and gain on life insurance policies, while excluding actuarial gain;
- Retaining the present-law tax treatment of company-owned life insurance (COLI).

K. Working Group on Real Estate

Commentators offered various suggestions to the Real Estate Working Group.

Many comments urge the retention of present law or the expansion of existing provisions. Some comments urge that, if any adverse changes are made, such changes provide transition relief to grandfather existing real estate investment.

Some of the comments submitted to the Real Estate Working Group have been reported under the comments for other working groups.

In the presentation below, following the general and transition comments, the comments appear in the order of relevant Code sections.

General

- Do not make any changes adverse to investment in real estate.

Transition

- If any adverse changes are made, do not affect existing real estate investment, that is, provide grandfathering relief for existing investment.

Capital gains rates (sec. 1)

- Retain lower rates on capital gain than on ordinary income.

Low income housing tax credit ("LIHTC") (sec. 42 and Sec. 142)

- Retain the LIHTC;
- Make permanent the nine-percent fixed floor credit rate for property not financed with tax-exempt bonds;
- Provide a permanent four-percent floor credit rate for property that is financed with tax-exempt bonds;
- Increase allocation authority by 50 percent;
- Amend the LIHTC "student rule" to allow formerly homeless youth who become students to stay.

New Markets Tax Credit ("NMTC") (sec. 45D)

- Make the NMTC permanent;
- Increase credit authority (no specific level mentioned);
- Index for inflation the annual level of allocations;
- Allow NMTC to be applied against the AMT;

- Do not replace NMTC in whole or part with a grant program.

Rehabilitation and Historic Tax Credits (sec. 47)

- Retain the present-law credits with certain modifications including with respect to tax-exempt use property;
- Increase the rehabilitation credit to 30 percent (from 20 percent) for certain smaller projects;
- For the rehabilitation credit, require that the building be first placed in service no less than 50 years before the qualified rehabilitation expenditures are taken into account (rather than before 1936);
- Add an energy-efficiency supplement to the credit;
- Exempt from taxable income the proceeds from the sale, allocation, other transfer, or refund of a State Historic Tax Credit.

Cancellation of indebtedness (COD) income (sec. 108).

- Allow broader exclusion of COD income, with attribute reduction and deferral for all types of taxpayers;
- Make permanent the qualified residence exception;
- Restore prior law qualified business debt exception;
- Restore prior law equity for debt exception, clarifying the rules for partnership COD income;
- Clarify COD rules for partnerships so partners may claim their share of partnership level debt in the personal partner level insolvency exception, as provided under Rev. Rul. 2014-12;
- Clarify that 108(e)(6) applies to partnerships, so forgiveness of debt owed to a partner-creditor becomes a nontaxable contribution to capital to the extent of the partner's adjusted basis in the debt;
- Clarify that retirement and other assets exempt from creditors under a taxpayer's applicable state law are not counted as assets in the 108(d)(3) insolvency calculation;
- Treat all nondeducted or limited interest, including personal interest, as if deductible for purposes of section 108(e)(2);

- Adopt Mr. Camp's financial products discussion draft[1633] proposal to eliminate phantom income by providing that the issue price of the new debt cannot be less than that of the old debt, reduced by any principal forgiveness.

Capital gains exclusion for principal residence (sec. 121)

- Retain present law;
- Index the present-law exclusion for inflation;
- Repeal present law exclusion for cash gain.

Private Activity Housing Bonds (sec. 142)

- Retain present law provisions and provide fixed floor of 4 percent for LIHTC projects financed with such bonds.

Mortgage Revenue Bonds and Mortgage Credit Certificates (sec. 143)

- Retain and expand present law (*e.g.*, repeal purchase price limit and simplify mortgage credit certificates).

Business interest deduction (sec. 162)

- Retain present law deductibility of business interest.

Mortgage Interest Deduction (sec. 163)

- Retain the present-law mortgage interest deduction without change (including for second homes and home equity loans). Do not adopt a credit. Do not cap amount of borrowing at FHA loan limits for an area;
- Change the mortgage interest deduction to increase its relative benefit to moderate and lower income taxpayers (*e.g.*, income under $100,000) and use savings to support low income housing;
- Cap the amount of borrowing on which the mortgage interest deduction may be taken to the FHA loan limits for the area, change the deduction to a 15 percent credit, and use savings to support low income housing;
- Cap borrowing at $500,000 of loan principal (inclusive of home equity and second homes) and change deduction to a 15 percent credit. Phase in changes over five years. Use savings to fund the National Housing Trust Fund;

[1633] Representative Camp, Chairman of the House Ways and Means Committee, released a discussion draft relating to the taxation of Financial Products, on January 24, 2013. A summary of the discussion draft may be found on the House Ways and Means Committee website, available at http://waysandmeans.house.gov/uploadedfiles/summary_description_of_wm_discussion_draft_financial_products.pdf.

- Make permanent the deduction for private mortgage insurance;
- Reduce otherwise allowable mortgage interest deduction by 10 percent;
- Retain the present-law mortgage interest deduction, but tax the rental value of personal use property for aggregate property worth more than $1 million per family, and disallow the deduction of property tax over the same $1 million threshold.

State and local property tax deductions (sec. 164)

- Retain present-law State and local property tax deductions.

Depreciation and expensing (secs. 168, 179, 198)

- Make permanent 15-year leasehold improvement depreciation;
- Shorten 15-year leasehold improvement depreciation or make it match the particular lease term;
- Shorten the period for building depreciation to 20 years for residential real property, 25 years for nonresidential;
- Shorten the period for both nonresidential and residential depreciation to between 22-24 years;
- Shorten the depreciation period for certain energy efficient roof systems of U.S. commercial buildings to 20 years;
- Shorten the depreciation period for commercial roofs to 20 years (some commentators also suggested that an economically realistic period would be somewhat under 20 years, for example, 17 years).
- Shorten the depreciation period for fire sprinkler systems in high-rise buildings to 15 years. Include sprinkler systems in the definition of section 179 property;
- Shorten the depreciation period for fire sprinkler retrofits to five years.
- Make section 179 expensing permanent at $250,000 (with an $800,000 phase-out) and allow it to be used for qualified real property.
- Reauthorize and make permanent the currently expired expensing of environmental remediation costs ("Brownfields")(sec. 198).

Energy efficient deduction (sec. 179D)

- Retain and expand section 179D;
- Increase the amount of the maximum deduction per square foot; expand the deduction to multifamily dwellings and expand the classes of taxpayers that can use the deduction to include real estate investment trusts ("REITs"); allow allocation by nonprofits or others to parties that can use the deduction and are engaged in the project (contractor, tenant, architect, or source of financing); create a new deduction for retrofits, measuring energy savings and improvement by reference to a building's

own baseline, and link amount of deduction to energy savings achieved (sliding scale).

- Extend and reform section 179D as suggested in a report by the American Council for an Energy Efficient Economy.[1634]

Unrelated business taxable income ("UBTI") of exempt organizations: rules relating to debt-financed real estate (Section 514(c)(9))

- Expand the types of qualified entities exempt from the debt-financed UBTI rules to include IRAs, foundations, and charities.
- Adopt American Bar Association recommendations to eliminate certain problems under the "fractions rule".

Partnership/passthrough rules

- Do not change present-law treatment of carried interest;
- If any change does occur: exempt real estate partnerships and family partnerships;
- If any change does occur, count as contributed capital the amounts a developer put at risk prior to creation of the partnership;
- Retain present law partnership, passthrough, and sole proprietor treatment, regardless of size;
- Harmonize the at-risk, passive loss, and allocation and basis rules.
- Repeal the at-risk rules and clarify the partnership rules to provide that distributions in excess of a partner's basis are measured only at year end and after all allocations including any special allocations.
- Retain partnership ability to make special allocations.
- Do not adopt Chairman Camp's "Option 2"[1635] for passthrough entities.
- Assure continuing umbrella partnership treatment (for example, real estate investment trust ("UPREIT") treatment) that receipt of right to exchange partnership interest for publicly traded stock is not a taxable event and does not adversely affect partnership treatment.

[1634] The Report is available at: http://aceee.org/research-report/e132.

[1635] Representative Camp, Chairman of the House Ways and Means Committee, released a discussion draft relating to the taxation of Passthrough entities, containing two options, on March 12, 2013. A summary of the discussion draft may be found on the House Ways and Means Committee website, available at: http://waysandmeans.house.gov/uploadedfiles/small_biz_summary_description_03_12_13_final.pdf

Real Estate Investment Trust ("REIT") rules (secs. 856 and 857, also secs. 562, 871, 7701)

- Modernize REIT rules by provisions including the following:
- Provide an alternative three-year averaging test (instead of the present law annual test) for determing whether the amount of property sales exceeds the prohibited transactions tax safe-harbor, that allows as much as 20 percent of basis or fair market value of properties to be disposed of within a year so long as the 10-percent three-year average test is met
- Allow taxable REIT subsidiaries to conduct certain activities currently required to be conducted by independent contractors,
- Repeal the preferential dividend rule for publicly offered REITs and allow alternative remedies where the rule still applies,
- Allow exemption to foreign REIT shareholders of certain interest-related dividends,
- Update and modify REIT income and asset tests, including allowing more investment in debt securities of publicly offered REITs making permanent and generally applicable certain mineral royalty income provisions, and reinstating permanently certain timber provisions, and
- Modify certain REIT earnings and profits calculations.

Real Estate Mortgage Investment Conduit ("REMIC") rules (sec. 860A et. seq).

- Prevent adverse effects to holders of interests in REMICs.
- IRS should enforce REMIC rules requiring proper acquisition and ownership of mortgages even if such enforcement would adversely affect REMIC interest holders.

Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897 and 1445)

- Repeal FIRPTA.
- If FIRPTA is not repealed, then increase to 10 percent the REIT publicly traded stock ownership exempt from FIRPTA, and repeal Treasury Notice 2007-55.
- If FIRPTA is not repealed, tax all foreign tax-exempt pension plans in the same manner that U.S. exempt pension plans are taxed on their U.S. real estate investments.

Like-kind exchanges (sec. 1031)

- Retain present law like-kind exchange rules in their entirety, including requirement for qualified intermediary ("QI") in a like-kind exchange.
- Retain present law like-kind exchange rules but simplify the rules by eliminating requirements under Treasury Regulations, such as the requirement to restrict the proceeds from sale of relinquished property until such proceeds are used to purchase replacement property and the requirement of notice that rights are assigned to an intermediary ("QI requirements").

- Modify rules to allow foreign real property to be exchanged for U.S. real property (but continue to exclude exchanges of U.S. for foreign property).
- Impose capital gains tax on like-kind exchanges and require an exchange broker to file an information return reporting the amount realized.

Other

- Provide a new Federal renters' tax credit, to provide assistance in the case of certain lower income renters. It is suggested that the credit might be paid for by revenue savings from other changes to the taxation of home ownership or other provisions. States would be authorized to allocate a capped amount of credits. The credit would be subject to a national cap (five billion dollars is mentioned). Initial eligibility for the credit would be limited by income of the renter. The credit could be claimed by a building owner, a bank or other mortgage holder. States could distribute the credit by issuing credit certificates to families, or by allocating credits to specific developments or to lenders.

L. Working Group on Small Business/Pass Throughs

The Working Group on Small Business/Pass Throughs ("Working Group") received public comments that cover a wide range of issues, which are summarized in this section. The summaries are organized into five broad categories: (1) comprehensive tax reform; (2) specific provisions, including continuing specific provisions; (3) entities; (4) other provisions; and (5) Chairman Camp's discussion draft.

1. Comprehensive tax reform

Several comments express support for Congress to undertake comprehensive tax reform (including the corporate, passthrough, and individual tax regimes) that broaden the base, lower tax rates, and maintain parity between corporate and passthrough entities. Several comments also express support for Congress to simplify the Code, restore certainty by making all provisions permanent, and reduce compliance burdens.

Other comments received by the Working Group can be grouped into four general categories: (1) tax rates; (2) overall tax reform; (3) tax treatment of passthrough entities and their owners; and (4) tax treatment of corporate entities. A summary of the recommendations provided in these categories is below.

<u>Tax rates</u>

- Set the top individual income tax rate at an amount not higher than the top corporate income tax rate;
- Reduce the top individual income tax rate below the top corporate income tax rate;
- Create a business equivalency rate whereby business income of passthrough entities is taxed at the top corporate income tax rate; and
- Reduce the employer's share of payroll taxes.

<u>Overall tax reform</u>

- Shift from the current worldwide system of taxation to a territorial tax system;
- Ensure appropriate transition relief; and
- Rationalize filing dates for partnership, S corporation, and C corporation returns.

<u>Tax treatment of passthrough entities and their owners</u>

- Maintain the current structure for passthrough entities, including the use of partnership allocations for specific costs *(e.g.*, intangible drilling costs);
- Reform the passive activity loss limitation rules;
- Permit tax deferral for corporations converting to passthrough form;
- Do not subject large passthrough entities to C corporation tax rates;

- Change the tax treatment of property distributions;
- Repeal section 736 (dealing with income tax aspects of payments by a partnership to a retiring partner or to the successor of a deceased partner in liquidation); and
- Make section 743(b) (relating to adjustments to basis of partnership property on sale or exchange of a partnership interest or on the death of a partner) adjustments mandatory and repeal section 704(c)(1)(C) (dealing with consequences from the contribution of property with built-in loss to a partnership).

Tax treatment of corporate entities

- Reinstate tax-free liquidations/conversions;
- Continue to reduce the incidence of double tax; and
- Extend the check-the-box rules under section 7701 to most privately owned corporations.

2. Specific provisions

Section 179

Several comments express support for Congress to make permanent and index for inflation the current maximum amount that a taxpayer may expense ($500,000) and the current phase-out amount ($2,000,000) under section 179. Other comments recommend making permanent the prior law $250,000/$800,000 expensing and phase-out levels.

Depreciation

Several comments express support for Congress to reform the depreciation rules. A summary of these comments is below.

- Reform the depreciation schedules to reflect the useful lives;
- Make permanent bonus depreciation;
- Make permanent 15-year depreciation for leasehold improvements, restaurant improvements and, and retail improvements;
- Change farm and ranch equipment recovery period to five years (to match construction equipment);
- Modify the current depreciation period for buildings and contents;
- Shorten the 39-year depreciation period for commercial roofs to reflect actual 17-year average life span; and
- Allow immediate expensing for all capital investment in equipment.

Research and development credit

Several comments express support for Congress to make permanent the research and development credit. A summary of other suggestions for reform is provided below.

- Allow the research and development credit to offset any alternative minimum tax liability;
- Increase the research and development credit if the manufacturing is performed in the United States;
- Allow the alternative simplified credit election on amended returns;
- Reign in the IRS regarding unreasonable record keeping requirements for small and medium businesses; and
- Create a new payroll tax credit for startups that cannot claim the research and development credit.

Alternative Minimum Tax ("AMT")

Several comments urge Congress to repeal the AMT, permit a deduction for AMT, or increase corporate AMT relief from the current $7.5 million to $10 million.

Capital gains

Several comments urge Congress to eliminate or reduce the capital gains tax, and repeal the 3.8 percent tax on net investment income. Additional comments recommend providing an exclusion from capital gains tax for farmland that remains in agriculture or is sold to a family member to continue the business.

Tax accounting provisions

Several comments urge Congress to modify tax accounting provisions concerning (1) cash accounting, (2) inventory, and (3) the long-term contract method. A summary of the recommendations provided in these categories is below.

Cash accounting

- Continue the unrestricted use of cash accounting for most passthrough businesses by not expanding section 448 to additional taxpayers;[1636]
- Raise the gross receipts test under section 448 from $5 million to $10 million; and
- Provide simplified cash accounting rules (*e.g.,* "checkbook" accounting, immediate expensing of inventory).

[1636] Under present law, section 448 generally prohibits C corporations and partnerships with C corporation partners from using the cash method of accounting if their gross receipts exceed $5 million.

Inventory

- Do not repeal the last-in, first out ("LIFO") method of accounting;
- Do not repeal the lower of cost or market ("LCM") accounting method for valuing inventory;
- Taxpayers using the cash method of accounting should not be required to maintain inventories under section 471;
- Repeal section 263A (requiring capitalization and inclusion in inventory costs of certain expenses); and
- Expand the current gross receipts exception under section 263A to producers and increase the exemption amount from $10 million of gross receipts to $100 million, indexed for inflation.

Long-term contract method

- Increase and index the completed contract method threshold under section 460 from $10 million of gross receipts to $40 million;
- Modify the look-back rules to exempt contracts spanning less than 36 months with a $25 million gross price threshold; and
- Repeal the look-back rules.

Continuing specific provisions

Several comments express support for certain present-law income tax deductions and preferences. Specifically, comments urge Congress to continue:

- The deduction under section 199 for architects;
- Benefits for farmers, including farm income averaging (and to extend the period from current three years to five years); immediate expensing of soil and water conservation expenditures; current deduction for the cost of raising dairy and breeding cattle, the cost of raising timber, and reforestation expenses; depreciation of single purpose agricultural structures over shorter lives; deferral of commodity and product receipts; and current deduction for prepaid livestock feed, fertilizer, and other farm supplies;
- The deduction for State and local property taxes;
- The current deduction for intangible drilling costs under section 263(c);
- Allowing deferral of gain under the like-kind exchange rules of section 1031;
- Retain current section 704 tax treatment of partnership special allocations;
- The capital gains tax treatment for carried interest; and
- The current deduction for interest expense incurred in a business.

3. Entities

Sole proprietors

Several comments urge Congress to simplify the Code with a focus on encouraging entrepreneurship and minimizing the administrative compliance burden for self-employed individuals. Specifically, comments encourage Congress to:

- Raise the self-employment exemption amount to the standard deduction amount;
- Simplify depreciation calculators, reporting requirements, and accelerated options for most standard business items and amounts, all of which could be included as a line on Schedule C; and
- Provide additional safe harbors (similar to the home office deduction) providing standard deduction options based on industry and location.

S corporation provisions

Several comments urge Congress to modify many of the rules under subchapter S. Specifically, comments encourage Congress to:

- Remove the limit on the number of S corporation shareholders;
- Allow S corporations to have nonresident aliens as shareholders and potential current beneficiaries of electing small business trusts;
- Extend the time allowable to make an S corporation election;
- Allow S corporations to have more than a single class of stock;
- Make permanent the five-year built-in gains holding period;
- Increase to 60 percent (from present-law 25 percent) the test for excessive passive income;
- Repeal the rule providing for mandatory termination of S corporation elections for excessive passive investment income; and
- Add a new 120-day post-termination transition period under section 1377(b) beginning on the date that a taxpayer files an amended Form 1120S.

4. Other provisions

Certain comments express support for Congress to create new tax preferences or discontinue current tax preferences for small businesses. Specifically, comments encourage Congress to:

- Allow unused deductions and credits to be carried backwards or forwards;
- Allow farmers the flexibility to determine how much income to assign to a specific year;

- Allow the 200-percent declining balance depreciation method for livestock;
- Reduce the Federal excise tax on small brewers;
- Permit dividends to be tax deductible;
- Repeal section 118 for certain capital contributions by non-owners;
- Continue section 118 for certain capital contributions by non-owners and revise to apply to passthroughs;
- Repeal section 1202, which provides a partial exclusion for gain from certain small business stock;
- Permit Federal composite returns for passthrough entities (and permit payment at the entity level by election);
- Create a limited exclusion from income for debt forgiveness targeted to small businesses;
- Permit income averaging for small businesses;
- Continue present law under section 45B providing a FICA income tax credit and extend the benefit to salon industry workers;
- Consolidate the rules relating to the deduction of start-up and organizational expenditures and raise the $5,000 limit to $10,000;
- Allow current deduction of all startup costs;
- Prohibit deductions that would reduce a partner's capital account below zero;
- Extend the look-through rules of section 1(h)(9) to partnership distributions as well as sales of partnership interests to prevent conversion of unrecaptured section 1250 gain and potentially indefinite deferral;
- Harmonize the at-risk, passive loss, partnership allocation, and partner basis rules, or repeal the at-risk rules and provide that partnership distributions in excess of a partner's basis are measured only at year end and after all allocations;
- Allow transfer of partnership suspended losses between spouses and former spouses upon a section 1041(a) exchange;
- Repeal section 708(b)(1)(B) regarding partnership technical terminations;
- Clarify that husband and wife partnerships that are recognized under state law are eligible to elect qualified joint venture ("QJV") status under section 761(f), which allows married couples to elect to treat their qualifying business as a QJV and file tax forms as if they were each sole proprietors;
- Eliminate the "tax float" by requiring receivables to be included in income of cash basis taxpayers when the counterparty is an accrual method taxpayer; similarly, defer deductions for payables of accrual method taxpayers when the counterparty is a cash basis taxpayer; and

- Restore the business meal and entertainment deduction to 80 percent of costs incurred.

5. Chairman Camp's discussion draft

Many of the comments received specifically address provisions included in Chairman Camp's discussion draft (the "Chairman's draft").[1637] Most commentators support certain proposals in the Chairman's draft, some commentators suggest modifications to certain proposals in the Chairman's draft, and some commentators do not support certain proposals in the Chairman's draft, as indicated below.

General

- Support expanding the cash method of accounting such that the gross receipts test would be increased from $ 5 million to $10 million;
- Support expanding population of taxpayers subject to the cash method of accounting, but would revise the proposal to provide that cash basis taxpayers would not be required to maintain inventories;
- Do not support eliminating the exception for qualified personal service corporations such that they are subject to the general limitation on the use of the cash method of accounting;
- Support consolidating the rules for start-up expenditures and organizational expenditures and allowing taxpayers to elect to deduct up to $10,000 in total;
- Support moving back the filing date of partnerships returns to March 15 (for calendar year taxpayers) and moving forward the filing date of S corporations returns to March 31 and C corporations returns to April 15 (for calendar year taxpayers); and
- Do not support the new filing dates but instead recommend all returns should be filed April 15.

Option 1

- Support extending the time for filing an S corporation election to the due date (with extensions) for filing the corporation's tax return;
- Support allowing non-resident aliens to be current beneficiaries of an electing small business trust but recommends taking the proposal a step further and eliminating the non-resident alien shareholder restriction provided in section 1361(b)(1)(C); and
- Support repealing the guaranteed payment.

[1637] Chairman Camp's discussion draft is provided on the House Committee on Ways and Means website, available at http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_legislative_text_03.12.13.pdf.

Option 2

- Support unifying the S corporation and partnership rules;
- Do not support creating uniform rules for passthroughs; and
- Commentators that did not support the uniform rules for passthroughs do support: (i) removing the limit on the number of S corporation shareholders; (ii) allowing S corporations to have nonresident aliens as shareholders; and (iii) allowing S corporations to have more than a single class of stock.

M. Other Suggestions and Comments

1. Broad-based tax reform

Certain public submissions received by the Committee advocate for large-scale changes to the tax system. These comments include the following proposals:

- Retaining the present-law income-based tax system, but reforming the system by lowering the rates and broadening the tax base;
- Replacing the income tax with a consumption-based tax system;
- Replacing the current tax system with the Fair Tax. The Fair Tax would replace all Federal income taxes, payroll taxes, and estate and gift taxes with a national retail sales tax;
- Specifically suggesting that the Fair Tax not be adopted;
- If the Fair Tax is adopted, do not include the provision that imposes a tax on the purchase of a home;
- Replacing the current corporate tax with an 0.8 percent annual tax on market capitalization;
- Repealing the Patient Protection and Affordable Care Act ("PPACA")[1638] and the Health Care and Education Reconciliation Act of 2010 ("HCERA"),[1639] (collectively referred to as the "Affordable Care Act" or "ACA").

2. Estate and gift taxes

<u>Repeal or retention of Federal wealth transfer taxes</u>

Several submissions call generally for the retention or repeal of one or more of the Federal wealth transfer taxes. Specifically, various submissions ask Congress to:

- Repeal the estate tax;
- Repeal both the estate tax and the gift tax;
- Repeal the estate tax and replace it with a tax on appreciation that is not imposed until an inherited asset is sold by an heir (*i.e.*, carry over basis in the inherited asset);
- Retain the current estate tax rules.

[1638] Pub. L. No 111-148 (2010).

[1639] Pub. L. No. 111-152 (2010).

Other comments express support for repeal of the estate tax, but suggest as an alternative a reduction in the estate tax in the event full repeal is not possible. These submissions include proposals to:

- Increase the estate and gift tax exemptions (indexed for inflation) until such time as repeal is achieved;
- Significantly reduce the estate tax if repeal is not possible;
- If repeal is not possible, set the estate tax exemption amount at $3.5 million (indexed for inflation) and enact the lowest possible estate tax rate;
- Retain the current transfer tax laws while working toward replacing the estate, gift, and generation skipping transfer taxes with a more reasonable and less burdensome alternative.

Estate tax valuation rules

Several submissions relate to the special-use valuation rules for certain farm and other business real property under section 2032A. The submissions ask Congress to:

- Increase the maximum permitted reduction in value under the provision;
- Modify the provision so that a sale of a conservation easement is not a disposition that results in recapture of the tax benefit;
- Modify the rules of the provision that relate to harvesting of timber.

Basis of assets acquired from a decedent

Some submissions urge Congress to retain the rule under which assets acquired from a decedent take a basis that is stepped up to fair market value as of the date of death (or the alternate valuation date). Others, however, propose repealing the step-up in basis rules for assets acquired from a decedent.

3. Compensation and employee benefits (other than retirement benefits)

Health and other benefits

Comments suggest:

- With respect to cafeteria plans, (1) eliminating the use-or-lose requirement, (2) allowing long-term care insurance to be offered through a cafeteria plan, and (3) allowing health benefits to be offered to retirees through a cafeteria plan;
- Allowing over-the-counter medicines to be reimbursed under an employer-sponsored health plan without a prescription;
- Allowing employer-sponsored health plans to cover medical expenses of any beneficiary of a deceased employee (not limited to a spouse, dependent, or child under age 27);

- Repealing the excise tax on high cost employer-provided coverage;
- Expanding the ability to make contributions to a health savings account ("HSA") and the types of medical expenses that can be paid from an HSA;
- Allowing a higher exclusion for employer-provided dependent care and increasing the compensation threshold for disregarding lower-paid employees in nondiscrimination testing;
- Providing the same amount of exclusion for transit benefits and parking on a permanent basis;
- Allowing sole proprietors, partners (including members of an LLC treated as a partnership) and two-percent shareholders of an S corporation to receive health and other fringe benefits on a pretax basis, including through a cafeteria plan;
- Imposing a nondeductible 50-percent entity-level tax on a business's or exempt organization's cost of various fringe benefits (such as meals, entertainment, dining and athletic facilities) provided to employees or other service providers, customers or suppliers, less any amount paid by the employees, other service providers, customers or suppliers and any amounts reported as taxable compensation.

Nonqualified deferred compensation

Comments suggest:

- Amending the statutory rules for nonqualified deferred compensation[1640] to apply only to key employees of public companies;
- Taxing nonqualified deferred compensation at the same rate as in effect for the year(s) of deferral;
- Determining the amount of additional tax under section 409A by reference to the tax owed on the nonqualified deferred compensation, rather than by reference to the amount of nonqualified deferred compensation.

Worker classification and payroll taxes

Comments suggest:

- Providing a safe harbor that allows independent contractor classification if the worker performs services through a business entity, such as a corporation or limited liability company, subject to a Form 1099 being issued to the worker by the service recipient;
- Providing a worker classification standard that allows a business and worker to determine contractually the status of the worker;

[1640] Sec. 409A

- Retaining section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, which allows a business to treat workers as not being employees if certain requirements are met, regardless of the actual status of the workers;
- Allowing individual State and local government employees, not otherwise covered by Medicare taxes, to elect to be treated as self-employed individuals for purposes of Medicare taxes (and benefits);
- Allowing professional employer organizations ("PEOs") to be solely liable for the collection and payment to the IRS of employment taxes with respect to wages paid to worksite employees of PEO clients;
- Allowing an employer with combined income tax withholding and Federal Insurance Contributions Act ("FICA") taxes for the year that do not exceed $50,000 to file an annual employment tax return (as currently permitted if an employer's income tax withholding and FICA taxes for the year do not exceed $1,000), rather than quarterly employment tax returns;
- Allowing self-employed individuals to deduct their health insurance premiums as a business expense, that is, for income and Self-Employment Contributions Act ("SECA") purposes;
- Repealing the additional Medicare taxes on high income individuals;
- With respect to income tax withholding, (1) requiring withholding from compensation of any service provider (including a nonemployee) whose compensation is, or is expected to be, at least $2,000 a month, (2) requiring withholding from all compensation of all service providers (subject to a de minimis exception) if the total amount paid to all exceeds $5,000 a month, (3) conditioning a deduction (or addition to the basis of an asset) for compensation on compliance with required income tax withholding or payment of the tax by the compensation recipient.

4. Tax-exempt bond and tax credit bonds

<u>All present-law tax-exempt bond related rules, generally</u>

Comments suggest:

- Retaining all of the present-law rules for tax-exempt bonds;
- Repealing the tax exemption for municipal bonds.

<u>Select present-law tax-exempt bond and tax credit bond related rules</u>

Comments suggest:

- Rejecting proposals that would convert tax-exempt bonds into tax credit or direct-pay tax credit bonds generally;
- Expanding and/or permanently extending Qualified Zone Academy Bonds, new Clean Renewable Energy Bonds ("CREBs"), and Build America Bonds, respectively;

- Retaining the present-law rules for tax-exempt financing for non-profit hospitals;
- Repealing the AMT preference for interest on tax-exempt bonds.

Other submissions

Other submissions suggest:

- Increasing flexibility under the present-law rules relating to bond financing for energy utilities;
- Expanding present law so that pre-pay power purchase agreements can be financed with tax-exempt bonds;
- Removing State private activity volume limits for community water projects;
- Expanding present law to increase eligibility for small-issue bonds;
- Expanding present law to increase deductibility of interest by certain financial institutions investing in tax-exempt debt.

Tribal government related tax-exempt bond rules

Comments suggest:

- Repealing the "essential government function test" so that Indian tribal governments could utilize tax-exempt bond financing for additional types of projects; and
- Enacting of the President's fiscal year 2014 ("FY2014") Budget proposal for a separate tax-exempt bond volume limitation on Indian tribal government bonds.

Limiting the benefit of certain items for upper-income taxpayers

- Imposing a limitation on itemized deductions and exclusions (including tax-exempt bond interest) as proposed in the President's FY2014 budget or similar proposals.

5. Income tax and accounting

Comments suggest:

- Repealing the recurring item exception from economic performance rules;
- Eliminating deductions for entertainment expenses;
- Disallowing a deduction of basis if property has retained its value in excess of basis;
- Disallowing a deduction for amounts paid to tax lawyers and accountants for tax planning and controversy costs;
- Clarifying that a contractual payment obligation received by a service provider is subject to immediate taxation under section 83 if the obligor is a person other than the recipient of the service provider's services.

6. Procedural and compliance-related matters

Comments suggest:

- Simplifying the reporting of cancellation of indebtedness income;
- Making various compliance improvements to eliminate the "tax gap," such as raising the reporting standard to "more likely than not," requiring taxpayer correction of errors on amended returns, enacting web-based tax liens, and withholding on interest and sales;
- Providing for explicit disclosure to a parent in the case of the theft of the Social Security number of a deceased infant;
- Requiring the IRS to create electronic tax forms so individuals do not have to pay private companies; make more information automated so taxpayers do not have to enter as much information manually;
- Passing legislation to ensure that the IRS's commercial tax preparer initiative moves forward to improve competency of tax preparers and decrease errors related to EITC and child tax credit;
- Strengthening the Volunteer Income Tax Assistance services – including authorizing a grant program in the Code, authorizing annual grant funding of up to $30 million for five years, establishing a National Center to Promote Quality, Excellence, and Evaluation in VITA, and increasing flexibility to VITA centers to meet local needs to support asset-building and financial-education efforts.

7. Additional comments

A number of comments submitted to the Committee did not fall neatly into one of the Working Group areas or topics described above. Those comments include:

- Standardizing the allowable mileage rate for business expense, medical expense, mileage expense and charitable contribution purposes;
- Exempting gaming losses from any new limits on itemized deductions (*e.g.*, capping itemized deductions as a percentage of income or allowing itemized deductions at a lower than the otherwise applicable tax rate for certain high-income taxpayers).
- Repealing the lower-rate corporate income tax brackets;
- Allowing certain attorneys fees and court costs as a deduction from gross income;
- Creating a uniform system for inflation adjustments in the tax code;
- Restoring section 45O, the agricultural chemicals security credit;
- Restoring volunteer firefighter income exclusion and raise the monthly limit;
- Repealing the excise tax on medical devices.

APPENDIX 1: FEBRUARY 13, 2013 PRESS RELEASE

Press Release

Camp and Levin Announce Ways and Means Tax Reform Working Groups

11 Working Groups Will Report Findings Back to Full Committee

Wednesday, February 13, 2013

Washington, DC - Today, Ways and Means Committee Chairman Dave Camp (R-MI) and Ranking Member Sandy Levin (D-MI) announced the formation of 11 separate Ways and Means Committee Tax Reform Working Groups.

The groups will be led by one Republican Member serving as Chair and one Democratic Member serving as Vice Chair. Each of the 11 groups will review current law in its designated issue area and then identify, research and compile feedback related to the topic of the working group. The working groups will be responsible for compiling feedback on its designated topic from: (1) stakeholders, (2) academics and think tanks, (3) practitioners, (4) the general public and (5) colleagues in the House of Representatives. Once the work of those groups has been completed, the Joint Committee on Taxation will prepare a report for the full Committee, due by April 15, 2013, that describes current law in each issue area and summarizes the other information gathered by the Committee Members.

Announcing the formation of the groups, Chairman Camp stated, "I am pleased to be working collaboratively with Ranking Member Levin and all of our Committee Members as we continue our efforts to fix our broken tax code. Regardless of party or politics, everyone can agree that comprehensive tax reform should result in a simpler, fairer tax code for families and more jobs for American workers. In addition to Committee hearings, these working groups will be one more way for the Committee to gather the necessary information to produce the best possible legislation."

Ranking Member Levin added, "Tax reform must build on a full understanding of present provisions as a path to a simpler, fairer and adequate tax code. These working groups provide a framework to undertake in-depth fact-finding on a variety of important issues related to tax reform."

The 11 working groups and their respective Chair and Vice Chair are listed below (groups listed in alphabetical order).

Charitable/Exempt Organizations	David Reichert (R-WA)	John Lewis (D-GA)
Debt, Equity and Capital	Kenny Marchant (R-TX)	Jim McDermott (D-WA)
Education and Family Benefits	Diane Black (R-TN)	Danny Davis (D-IL)
Energy	Kevin Brady (R-TX)	Mike Thompson (D-CA)
Financial Services	Adrian Smith (R-NE)	John Larson (D-CT)
Income and Tax Distribution	Lynn Jenkins (R-KS)	Joseph Crowley (D-NY)
International	Devin Nunes (R-CA)	Earl Blumenauer (D-OR)
Manufacturing	Jim Gerlach (R-PA)	Linda Sanchez (D-CA)
Pensions/Retirement	Pat Tiberi (R-OH)	Ron Kind (D-WI)
Real Estate	Sam Johnson (R-TX)	Bill Pascrell, Jr. (D-NJ)
Small Business/Pass Throughs	Vern Buchanan (R-FL)	Allyson Schwartz (D-PA)

APPENDIX 2: MARCH 1, 2013 PRESS RELEASE

Press Release

Ways and Means Committee Announces New Way to Contact Tax Reform Working Groups

Establishes tax.reform@mail.house.gov so stakeholders and the public can share information on current federal income tax law

Friday, March 01, 2013

Washington, DC - Today, the Ways and Means Committee announced a new email address, tax.reform@mail.house.gov as another way for stakeholders, advocacy groups and the public to share information, facts and data relevant to the Committee's review of current federal income tax law within the Committee's 11 Tax Reform Working Groups.

The working groups, announced earlier this month by Chairman Dave Camp (R-MI) and Ranking Member Sander Levin (D-MI), will review current law in their designated issue areas and then identify, research and compile feedback related to the topic of the working group. The working groups will be responsible for compiling feedback on their designated topic from: (1) stakeholders, (2) academics and think tanks, (3) practitioners, (4) the general public and (5) colleagues in the House of Representatives. Once the work of those groups has been completed, the Joint Committee on Taxation (JCT) will prepare a report for the full Committee that describes current law in each issue area and only summarizes these submissions and other information gathered by the Committee Members.

Those interested in sharing information, facts, and data can email their comments to the Committee. To ensure that comments are widely available and accessible, comments that are received will be posted on the Ways and Means website at www.waysandmeans.house.gov.

Public comments will be accepted through Monday, April 15, 2013. Those comments will be included in the final JCT report, which will be delivered to the Ways and Means Committee on Monday, May 6, 2013. The process for submitting comments is below.

Details for the Submission of Written Comments to the Tax Reform Working Groups

1. Any person(s) and/or organization(s) wishing to submit comments can email tax.reform@mail.house.gov.
2. In the subject line of the email, please indicate "Comments: (name of) Tax Reform Working Group" (note: be sure to specify the name of the working group in the subject line - e.g., Energy Tax Reform Working Group).
3. Attach your submission as a Word document.
4. In addition to the Word document attachment, please include in the body of the email a contact name, physical address, phone number and email address.
5. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-1721.

About the Tax Reform Working Groups

The 11 working groups are listed below (groups listed in alphabetical order).

Charitable/Exempt Organizations
Debt, Equity and Capital
Education and Family Benefits
Energy
Financial Services
Income and Tax Distribution
International
Manufacturing
Pensions/Retirement
Real Estate
Small Business/Pass Throughs