

---

General Explanations  
of the  
Administration's Fiscal Year 2014  
Revenue Proposals

---



Department of the Treasury  
April 2013



---

# General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals

---



Department of the Treasury  
April 2013

This document is available online at:

<http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>



## TABLE OF CONTENTS

<b>ADJUSTMENTS TO THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT (BBEDCA) BASELINE .....</b>	<b>1</b>
<i>Permanently Extend Increased Refundability of the Child Tax Credit.....</i>	<i>2</i>
<i>Permanently Extend Earned Income Tax Credit (EITC) for Larger Families and Married Couples .....</i>	<i>4</i>
<i>Permanently Extend the American Opportunity Tax Credit (AOTC).....</i>	<i>6</i>
<b>RESERVE FOR REVENUE-NEUTRAL BUSINESS TAX REFORM.....</b>	<b>9</b>
<b>INCENTIVES FOR MANUFACTURING, RESEARCH, CLEAN ENERGY, AND INSOURCING AND CREATING JOBS .....</b>	<b>10</b>
<i>Provide Tax Incentives for Locating Jobs and Business Activity in the United States and Remove Tax Deductions for Shipping Jobs Overseas.....</i>	<i>10</i>
<i>Provide New Manufacturing Communities Tax Credit .....</i>	<i>12</i>
<i>Enhance and Make Permanent the Research and Experimentation (R&amp;E) Tax Credit... </i>	<i>13</i>
<i>Extend Certain Employment Tax Credits Including Incentives for Hiring Veterans .....</i>	<i>14</i>
<i>Provide a Tax Credit for the Production of Advanced Technology Vehicles .....</i>	<i>16</i>
<i>Provide a Tax Credit for Medium- and Heavy-Duty Alternative-Fuel Commercial Vehicles .....</i>	<i>18</i>
<i>Modify and Permanently Extend Renewable Electricity Production Tax Credit .....</i>	<i>19</i>
<i>Modify and Permanently Extend the Deduction for Energy-Efficient Commercial Building Property.....</i>	<i>21</i>
<b>TAX RELIEF FOR SMALL BUSINESS .....</b>	<b>23</b>
<i>Extend Increased Expensing for Small Business .....</i>	<i>23</i>
<i>Eliminate Capital Gains Taxation on Investments in Small Business Stock .....</i>	<i>25</i>
<i>Double the Amount of Expensed Start-Up Expenditures .....</i>	<i>27</i>
<i>Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance.....</i>	<i>29</i>
<b>INCENTIVES TO PROMOTE REGIONAL GROWTH.....</b>	<b>31</b>
<i>Extend and Modify the New Markets Tax Credit (NMTC) .....</i>	<i>31</i>
<i>Restructure Assistance to New York City, Provide Tax Incentives for Transportation Infrastructure .....</i>	<i>32</i>
<i>Modify Tax-Exempt Bonds for Indian Tribal Governments .....</i>	<i>34</i>
<b>Reform and Expand the Low-Income Housing Tax Credit .....</b>	<b>37</b>
<i>Allow States to Convert Private Activity Bond Volume Cap into Low-Income Housing Tax Credits (LIHTCs) that the State can Allocate .....</i>	<i>37</i>
<i>Encourage Mixed Income Occupancy by Allowing Low-Income Housing Tax Credit (LIHTC)-Supported Projects to Elect a Criterion Employing a Restriction on Average Income .....</i>	<i>39</i>
<i>Change Formulas for 70 Percent PV and 30 Percent PV Low-Income Housing Tax Credits (LIHTCs) .....</i>	<i>41</i>
<i>Add Preservation of Federally Assisted Affordable Housing to Allocation Criteria .....</i>	<i>43</i>

<i>Make the Low-Income Housing Tax Credit (LIHTC) Beneficial to Real Estate Investment Trusts (REITs)</i> .....	44
<b>REFORM U.S. INTERNATIONAL TAX SYSTEM</b> .....	<b>46</b>
<i>Defer Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries</i> .....	46
<i>Determine the Foreign Tax Credit on a Pooling Basis</i> .....	48
<i>Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore</i> .....	49
<i>Limit Shifting of Income Through Intangible Property Transfers</i> .....	51
<i>Disallow the Deduction for Non-Taxed Reinsurance Premiums Paid to Affiliates</i> .....	52
<i>Limit Earnings Stripping By Expatriated Entities</i> .....	53
<i>Modify Tax Rules for Dual Capacity Taxpayers</i> .....	55
<i>Tax Gain from the Sale of a Partnership Interest on Look-Through Basis</i> .....	57
<i>Prevent Use of Leveraged Distributions from Related Foreign Corporations to Avoid Dividend Treatment</i> .....	59
<i>Extend Section 338(h)(16) to Certain Asset Acquisitions</i> .....	60
<i>Remove Foreign Taxes From a Section 902 Corporation’s Foreign Tax Pool When Earnings Are Eliminated</i> .....	61
<b>REFORM TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS</b> .....	<b>62</b>
<i>Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary</i> .....	62
<i>Modify Rules that Apply to Sales of Life Insurance Contracts</i> .....	64
<i>Modify Proration Rules for Life Insurance Company General and Separate Accounts</i> ..	65
<i>Expand Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance</i> 67	
<b>ELIMINATE FOSSIL FUEL PREFERENCES</b> .....	<b>69</b>
Eliminate Oil and Gas Preferences .....	69
<i>Repeal Enhanced Oil Recovery (EOR) Credit</i> .....	69
<i>Repeal Credit for Oil and Gas Produced from Marginal Wells</i> .....	70
<i>Repeal Expensing of Intangible Drilling Costs</i> .....	71
<i>Repeal Deduction for Tertiary Injectants</i> .....	73
<i>Repeal Exception to Passive Loss Limitation for Working Interests in Oil and Natural Gas Properties</i> .....	74
<i>Repeal Percentage Depletion for Oil and Natural Gas Wells</i> .....	75
<i>Repeal Domestic Manufacturing Deduction for Oil and Natural Gas Production</i> .....	77
<i>Increase Geological and Geophysical Amortization Period for Independent Producers to Seven Years</i> .....	78
Eliminate Coal Preferences.....	79
<i>Repeal Expensing of Exploration and Development Costs</i> .....	79
<i>Repeal Percentage Depletion for Hard Mineral Fossil Fuels</i> .....	81
<i>Repeal Capital Gains Treatment for Royalties</i> .....	83
<i>Repeal Domestic Manufacturing Deduction for the Production of Coal and Other Hard Mineral Fossil Fuels</i> .....	84
<b>OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS</b> .....	<b>86</b>
<i>Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives</i> .....	86
<i>Repeal Last-In, First-Out (LIFO) Method of Accounting for Inventories</i> .....	88

<i>Repeal Lower-Of-Cost-or-Market (LCM) Inventory Accounting Method.....</i>	<i>89</i>
<i>Modify Depreciation Rules for General Aviation Passenger Aircraft.....</i>	<i>90</i>
<i>Repeal Gain Limitation for Dividends Received in Reorganization Exchanges .....</i>	<i>91</i>
<i>Expand the Definition of Built-In Loss for Purposes of Partnership Loss Transfers.....</i>	<i>92</i>
<i>Extend Partnership Basis Limitation Rules to Nondeductible Expenditures.....</i>	<i>93</i>
<i>Limit the Importation of Losses under Related Party Loss Limitation Rules.....</i>	<i>94</i>
<i>Deny Deduction for Punitive Damages .....</i>	<i>95</i>
<i>Eliminate Section 404(k) Employee Stock Ownership Plan (ESOP) Dividend Deduction for Large C Corporations .....</i>	<i>96</i>

**BUDGET PROPOSALS.....99**

**TAX RELIEF TO CREATE JOBS AND JUMPSTART GROWTH..... 100**

<i>Provide Small Businesses a Temporary 10-Percent Tax Credit for New Jobs and Wage Increases .....</i>	<i>100</i>
<i>Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project .....</i>	<i>102</i>
<i>Designate Promise Zones .....</i>	<i>104</i>

**INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE..... 108**

<i>Provide America Fast Forward Bonds and Expand Eligible Uses .....</i>	<i>108</i>
<i>Increase the Federal Subsidy Rate for America Fast Forward Bonds for School Construction.....</i>	<i>110</i>
<i>Allow Current Refundings of State and Local Governmental Bonds .....</i>	<i>112</i>
<i>Repeal the \$150 Million Non-hospital Bond Limitation on Qualified Section 501(c)(3) Bonds.....</i>	<i>115</i>
<i>Increase National Limitation Amount for Qualified Highway or Surface Freight Transfer Facility Bonds .....</i>	<i>116</i>
<i>Eliminate the Volume Cap for Private Activity Bonds for Water Infrastructure.....</i>	<i>117</i>
<i>Increase the 25-Percent Limit on Land Acquisition Restriction on Qualified Private Activity Bonds .....</i>	<i>119</i>
<i>Allow More Flexible Research Arrangements for Purposes of the Private Business Use Limits.....</i>	<i>120</i>
<i>Repeal the Government Ownership Requirement for Certain Types of Exempt Facility Bonds.....</i>	<i>122</i>
<i>Exempt Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act (FIRPTA).....</i>	<i>123</i>

**TAX CUTS FOR FAMILIES AND INDIVIDUALS..... 124**

<i>Provide for Automatic Enrollment in Individual Retirement Accounts or Annuities (IRAs), Including a Small Employer Tax Credit, and Double the Tax Credit for Small Employer Plan Start-Up Costs.....</i>	<i>124</i>
<i>Expand the Child and Dependent Care Tax Credit.....</i>	<i>128</i>
<i>Extend Exclusion from Income for Cancellation of Certain Home Mortgage Debt.....</i>	<i>129</i>
<i>Provide Exclusion from Income for Student Loan Forgiveness for Students in Certain Income-Based or Income-Contingent Repayment Programs Who Have Completed Payment Obligations.....</i>	<i>131</i>

<i>Provide Exclusion from Income for Student Loan Forgiveness and for Certain Scholarship Amounts for Participants in the Indian Health Service (IHS) Health Professions Programs</i> .....	132
<b>UPPER-INCOME TAX PROVISIONS</b> .....	<b>134</b>
<i>Reduce the Value of Certain Tax Expenditures</i> .....	134
<i>Implement the Buffett Rule by Imposing a New “Fair Share Tax”</i> .....	136
<b>MODIFY ESTATE AND GIFT TAX PROVISIONS</b> .....	<b>138</b>
<i>Restore the Estate, Gift, and Generation-Skipping Transfer (GST) Tax Parameters in Effect in 2009</i> .....	138
<i>Require Consistency in Value for Transfer and Income Tax Purposes</i> .....	140
<i>Require a Minimum Term for Grantor Retained Annuity Trusts (GRATs)</i> .....	142
<i>Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption</i> .....	143
<i>Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts</i> .....	145
<i>Extend the Lien on Estate Tax Deferrals Provided Under Section 6166 of the Internal Revenue Code</i> .....	147
<i>Clarify Generation-Skipping Transfer (GST) Tax Treatment of Health and Education Exclusion Trusts (HEETs)</i> .....	148
<b>REFORM TREATMENT OF FINANCIAL INDUSTRY INSTITUTIONS AND PRODUCTS</b> .....	<b>149</b>
<i>Impose a Financial Crisis Responsibility Fee</i> .....	149
<i>Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt</i> .....	151
<i>Require that the Cost Basis of Portfolio Stock That is a Covered Security Must be Determined Using an Average Basis Method</i> .....	152
<b>OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS</b> .....	<b>153</b>
<i>Increase Oil Spill Liability Trust Fund Financing Rate by One Cent and Update the Law to Include Other Sources of Crudes</i> .....	153
<i>Reinstate and Extend Superfund Excise Taxes</i> .....	154
<i>Reinstate Superfund Environmental Income Tax</i> .....	155
<i>Increase Tobacco Taxes and Index for Inflation</i> .....	156
<i>Make Unemployment Insurance Surtax Permanent</i> .....	157
<i>Provide Short-Term Tax Relief to Employers and Expand Federal Unemployment Tax Act (FUTA) Base</i> .....	158
<i>Tax Carried (Profits) Interests as Ordinary Income</i> .....	159
<i>Eliminate the Deduction for Contributions of Conservation Easements on Golf Courses</i> .....	161
<i>Restrict Deductions and Harmonize the Rules for Contributions of Conservation Easements for Historic Preservation</i> .....	162
<i>Require Non-Spouse Beneficiaries of Deceased Individual Retirement Account or Annuity (IRA) Owners and Retirement Plan Participants to Take Inherited Distributions Over No More than Five Years</i> .....	163
<i>Limit the Total Accrual of Tax-Favored Retirement Benefits</i> .....	165
<b>REDUCE THE TAX GAP AND MAKE REFORMS</b> .....	<b>168</b>
<i>Expand Information Reporting</i> .....	168



<i>Require Information Reporting for Private Separate Accounts of Life Insurance Companies</i> .....	168
<i>Require a Certified Taxpayer Identification Number (TIN) from Contractors and Allow Certain Withholding</i> .....	169
<i>Modify Reporting of Tuition Expenses and Scholarships on Form 1098-T</i> .....	170
<i>Improve Compliance by Businesses</i> .....	172
<i>Require Greater Electronic Filing of Returns</i> .....	172
<i>Make E-Filing Mandatory for Exempt Organizations</i> .....	174
<i>Authorize the Department of the Treasury to Require Additional Information to be Included in Electronically Filed Form 5500 Annual Reports and Electronic Filing of Certain Other Employee Benefit Plan Reports</i> .....	175
<i>Implement Standards Clarifying When Employee Leasing Companies Can Be Held Liable for Their Clients' Federal Employment Taxes</i> .....	177
<i>Increase Certainty with Respect to Worker Classification</i> .....	179
<i>Repeal Special Estimated Tax Payment Provision for Certain Insurance Companies</i> ..	182
<i>Strengthen Tax Administration</i> .....	184
<i>Impose Liability on Shareholders Participating in "Intermediary Transaction Tax Shelters" to Collect Unpaid Corporate Income Taxes</i> .....	184
<i>Increase Levy Authority for Payments to Medicare Providers with Delinquent Tax Debt</i> .....	186
<i>Implement a Program Integrity Statutory Cap Adjustment for Tax Administration</i> .....	187
<i>Streamline Audit and Adjustment Procedures for Large Partnerships</i> .....	188
<i>Revise Offer-in-Compromise Application Rules</i> .....	191
<i>Expand Internal Revenue Service (IRS) Access to Information in the National Directory of New Hires for Tax Administration Purposes</i> .....	192
<i>Make Repeated Willful Failure to File a Tax Return a Felony</i> .....	193
<i>Facilitate Tax Compliance with Local Jurisdictions</i> .....	194
<i>Extend Statute of Limitations where State Adjustment Affects Federal Tax Liability</i> ....	195
<i>Improve Investigative Disclosure Statute</i> .....	197
<i>Require Taxpayers Who Prepare Their Returns Electronically but File Their Returns on Paper to Print Their Returns with a 2-D Bar Code</i> .....	198
<i>Allow the Internal Revenue Service (IRS) to Absorb Credit and Debit Card Processing Fees for Certain Tax Payments</i> .....	199
<i>Extend IRS Math Error Authority in Certain Circumstances</i> .....	200
<i>Impose a Penalty on Failure to Comply with Electronic Filing Requirements</i> .....	202
<i>Restrict Access to the Death Master File (DMF)</i> .....	203
<i>Provide Whistleblowers with Protection from Retaliation</i> .....	204
<i>Provide Stronger Protection from Improper Disclosure of Taxpayer Information in Whistleblower Actions</i> .....	205
<i>Index All Penalties to Inflation</i> .....	207
<i>Extend Paid Preparer Earned Income Tax Credit (EITC) Due Diligence Requirements to the Child Tax Credit</i> .....	208
<i>Extend Internal Revenue Service (IRS) Authority to Require a Truncated Social Security Number (SSN) on Form W-2</i> .....	209
<i>Add Tax Crimes to the Aggravated Identity Theft Statute</i> .....	211
<i>Impose a Civil Penalty on Tax Identity Theft Crimes</i> .....	212

<b>SIMPLIFY THE TAX SYSTEM.....</b>	<b>213</b>
<i>Simplify the Rules for Claiming the Earned Income Tax Credit (EITC) for Workers Without Qualifying Children .....</i>	<i>213</i>
<i>Modify Adoption Credit to Allow Tribal Determination of Special Needs.....</i>	<i>214</i>
<i>Eliminate Minimum Required Distribution (MRD) Rules for Individual Retirement Account or Annuity (IRA)/Plan Balances of \$75,000 or Less .....</i>	<i>215</i>
<i>Allow All Inherited Plan and Individual Retirement Account or Annuity (IRA) Balances to be Rolled Over Within 60 Days .....</i>	<i>217</i>
<i>Repeal Non-Qualified Preferred Stock (NQPS) Designation.....</i>	<i>219</i>
<i>Repeal Preferential Dividend Rule for Publicly Offered Real Estate Investment Trusts (REITs).....</i>	<i>220</i>
<i>Reform Excise Tax Based on Investment Income of Private Foundations .....</i>	<i>222</i>
<i>Remove Bonding Requirements for Certain Taxpayers Subject to Federal Excise Taxes on Distilled Spirits, Wine and Beer.....</i>	<i>223</i>
<i>Simplify Arbitrage Investment Restrictions .....</i>	<i>225</i>
<i>Simplify Single-Family Housing Mortgage Bond Targeting Requirements .....</i>	<i>227</i>
<i>Streamline Private Business Limits on Governmental Bonds.....</i>	<i>228</i>
<i>Exclude Self-Constructed Assets of Small Taxpayers from the Uniform Capitalization (UNICAP) Rules.....</i>	<i>229</i>
<i>Repeal Technical Terminations of Partnerships.....</i>	<i>231</i>
<i>Repeal Anti-Churning Rules of Section 197 of the Internal Revenue Code .....</i>	<i>232</i>
<b>USER FEE .....</b>	<b>233</b>
<i>Reform Inland Waterways Funding .....</i>	<i>233</i>
<b>OTHER INITIATIVES.....</b>	<b>234</b>
<i>Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents.....</i>	<i>234</i>
<i>Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of the Economy.....</i>	<i>235</i>
<i>Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration (TIGTA).....</i>	<i>237</i>
<i>Modify Indexing to Prevent Deflationary Adjustments.....</i>	<i>238</i>
<i>Replace the Consumer Price Index (CPI) with the Chained CPI for Purposes of Indexing Tax Provisions for Inflation.....</i>	<i>240</i>
 <b>TABLES OF REVENUE ESTIMATES .....</b>	 <b>241</b>
<i>Table 1: Revenue Estimates of Adjustments to the Balanced Budget and Emergency Deficit Control Act (BBEDCA) Baseline.....</i>	<i>241</i>
<i>Table 2: Revenue Estimates of Reserve for Revenue-Neutral Business Tax Reform Proposals.....</i>	<i>242</i>
<i>Table 3: Revenue Estimates of FY 2014 Budget Proposals.....</i>	<i>244</i>

# **ADJUSTMENTS TO THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT (BBEDCA) BASELINE**

---

The BBEDCA baseline, which is commonly used in budgeting and is defined in the statute, reflects, with some exceptions, the projected receipts level under current law, including the American Taxpayer Relief Act of 2012 (ATRA). However, while ATRA made much middle-class tax relief permanent, it extended the American Opportunity Tax Credit (AOTC), Earned Income Tax Credit (EITC) expansions, and Child Tax Credit (CTC) expansions only through 2017. This Budget uses an adjusted baseline that is intended to be more realistic. The adjusted baseline permanently continues the AOTC, EITC, and CTC expansions extended through 2017 in ATRA.

## **PERMANENTLY EXTEND INCREASED REFUNDABILITY OF THE CHILD TAX CREDIT**

### **Current Law**

An individual may claim a \$1,000 tax credit for each qualifying child. A qualifying child must meet the following four tests:

1. Relationship – The child generally must be the taxpayers' son, daughter, grandchild, sibling, niece, nephew, or foster child.
2. Residence – The child must live with the taxpayer in the same principal place of abode for over half the year.
3. Support – The child must not have provided more than half of his or her own support for the year.
4. Age – The child must be under the age of 17.

For purposes of the child tax credit, a qualifying child must be a citizen, national, or resident of the United States. The child tax credit is phased out at a rate of \$50 for each \$1,000 of modified adjusted gross income over \$75,000 for unmarried taxpayers, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns.

The child tax credit is partially refundable, meaning that it is available to workers who have no individual income tax liability. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and as made permanent by American Taxpayer Relief Act of 2012 (ATRA), individuals could receive a refundable amount (the additional child credit) equal to the lesser of the child tax credit remaining after offsetting income tax liability and 15 percent of earned income in excess of \$10,000 (indexed after 2001). Taxpayers with three or more children may determine the additional child tax credit using an alternative formula based on the extent to which a taxpayer's social security taxes exceed the taxpayer's Earned Income Tax Credit (EITC). The American Recovery and Reinvestment Act of 2009 reduced the earned income threshold to \$3,000 in tax years 2009 and 2010. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended this provision through 2012. ATRA extended this further through 2017. After 2017, the earned income threshold will increase to \$10,000 (indexed after 2001).

### **Reasons for Change**

Making the child tax credit partially refundable and reducing the earned income threshold makes additional tax relief available to the most vulnerable working families. Because the wages of low-income families have failed to keep up with inflation, continued indexing of the earned income threshold will result in a decreasing number of low-income families able to take advantage of the credit each year and smaller credits for the families who receive the credit.

**Proposal**

The adjusted baseline for this Budget makes permanent the reduction of the earned income threshold to \$3,000. The earned income threshold would not be indexed for inflation.

This change would be effective for taxable years beginning after December 31, 2017.

## **PERMANENTLY EXTEND EARNED INCOME TAX CREDIT (EITC) FOR LARGER FAMILIES AND MARRIED COUPLES**

### **Current Law**

Low and moderate-income workers may be eligible for a refundable EITC. Eligibility for the EITC is based on the presence and number of qualifying children in the worker's household, adjusted gross income (AGI), earned income, investment income, filing status, age, and immigration and work status in the United States. The amount of the EITC is based on the number of qualifying children in the worker's household, AGI, earned income, and filing status.

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a maximum range (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit).

The EITC provides additional benefits for families with more qualifying children and for married couples filing joint returns. In particular, the EITC phases in at a faster rate for workers with more qualifying children, resulting in a larger maximum credit and a longer phase-out range. Furthermore, the income at which the EITC begins to phase out occurs at a higher amount for married couples than for unmarried workers with the same number of children, thereby increasing the range of income over which married couples are eligible for the maximum credit.

Prior to tax year 2009, the credit reached its maximum at two or more qualifying children and the EITC began to phase out for married couples at income levels \$3,000 (indexed after 2008) higher than for unmarried workers. The American Recovery and Reinvestment Act (ARRA) increased the phase-in rate for families with three or more qualifying children from 40 percent to 45 percent and increased the beginning of the phase-out range for married couples to \$5,000 above the level for unmarried filers (indexed after 2009) through 2010. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended these provisions through 2012. The American Taxpayer Relief Act of 2012 (ATRA) made permanent the first \$3,000 increase in the beginning of the phase-out range and extended the remaining \$2,000 increase and the third child benefits through 2017. After 2017, workers with three or more qualifying children will receive the same EITC as similarly situated workers with two qualifying children, and the phase-out range for married couples will begin at \$3,000 (indexed after 2008) above the level for unmarried workers.

The end of the phase-in range and the beginning of the phase-out range are indexed for inflation. Hence, the maximum amount of the credit and the end of the phase-out range are effectively indexed. The following chart summarizes the EITC parameters for 2013.

## EITC Parameters for 2013

	Childless Taxpayers	Taxpayers with Qualifying Children		
		One Child	Two Children	Three or More
Phase-in rate	7.65%	34.00%	40.00%	45.00%
Minimum earnings for maximum credit	\$6,370	\$9,560	\$13,430	\$13,430
Maximum credit	\$487	\$3,250	\$5,372	\$6,044
Phase-out rate	7.65%	15.98%	21.06%	21.06%
Phase-out begins	\$7,970 (\$13,310 joint)	\$17,530 (\$22,870 joint)	\$17,530 (\$22,870 joint)	\$17,530 (\$22,870 joint)
Phase-out ends	\$14,340 (\$19,680 joint)	\$37,870 (\$43,210 joint)	\$43,038 (\$48,378 joint)	\$46,227 (\$51,567 joint)

To be eligible for the EITC, workers must have no more than \$3,300 of investment income. (This amount is indexed for inflation.)

### **Reasons for Change**

Families with more children face larger expenses related to raising their children than families with fewer children and tend to have higher poverty rates. The steeper phase-in rate and larger maximum credit for workers with three or more qualifying children helps workers with larger families meet their expenses while maintaining work incentives.

For married couples filing a joint return, the EITC is calculated based on joint earnings. Increasing the income at which the EITC begins to phase out provides tax relief for working families, including those with two earners.

### **Proposal**

The adjusted baseline for this Budget makes permanent the expansion of the EITC enacted as part of ARRA and temporarily extended by ATRA. Specifically, the phase-in rate of the EITC for workers with three or more qualifying children would be maintained at 45 percent and the phase-out range for married couples would begin at income levels \$5,000 higher than those for unmarried filers (indexed after 2009).

This change is effective for taxable years beginning after December 31, 2017.

## **PERMANENTLY EXTEND THE AMERICAN OPPORTUNITY TAX CREDIT (AOTC)**

### **Current Law**

The American Taxpayer Relief Act of 2012 (ATRA) extended the AOTC through tax year 2017. The AOTC was enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA) and extended to tax years 2010 and 2011 by the Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010. Taxpayers may claim an AOTC for 100 percent of the first \$2,000 plus 25 percent of the next \$2,000 of qualified tuition and related expenses (for a maximum credit of \$2,500) per student. The AOTC phases out for taxpayers with adjusted gross income (AGI) between \$80,000 and \$90,000 (\$160,000-\$180,000 for joint filers). These amounts are not indexed for inflation.

Prior to the ARRA, an individual taxpayer could claim a nonrefundable Hope Scholarship credit for 100 percent of the first \$1,200 and 50 percent of the next \$1,200 in qualified tuition and related expenses (for a maximum credit of \$1,800) per student. These amounts are indexed for inflation; the amounts that would have been in effect for 2013 are shown. The Hope Scholarship credit was available only for the first two years of postsecondary education. To qualify for either the AOTC or Hope credit, the student must be enrolled at least half-time.

Taxpayers may also claim a nonrefundable Lifetime Learning Credit (LLC) for 20 percent of up to \$10,000 in qualified tuition and related expenses (for a maximum credit of \$2,000, which is not indexed for inflation) per taxpayer.

In 2013, both the Hope credit and the LLC phase out between \$53,000 and \$63,000 of adjusted gross income (\$107,000 and \$127,000 if married filing jointly, indexed for inflation). In contrast, the AOTC is available to families with higher incomes.

In addition, through 2013, a taxpayer may claim an above-the-line deduction for qualified tuition and related expenses. The maximum amount of the deduction is \$4,000 and is not indexed for inflation. Taxpayers may claim only one education benefit per student on their tax return.

### **Reasons for Change**

The AOTC makes college more affordable for millions of middle-income families and for the first time makes college tax incentives partially refundable.

Under prior law, some low-income families (those without sufficient income tax liability) could not benefit from the Hope Scholarship credit or the LLC because they were not refundable. In 2012, the maximum available credit covered about 80 percent of tuition and fees at the average 2-year public institution, or about thirty percent of tuition and fees for an in-state student attending the average four-year public institution.

Unlike the Hope Scholarship credit that applies for only the first two years of college, the AOTC is available for the first four years of college. This may increase the likelihood that students will



stay in school and complete their degrees. More years of schooling translates into higher future incomes (on average) for students and a more educated workforce for the country.

The higher phase-out thresholds under the AOTC give targeted tax relief to an even greater number of middle-income families facing the high costs of college.

**Proposal**

The adjusted baseline for this Budget makes the AOTC a permanent replacement for the Hope Scholarship credit.

This change is effective for taxable years beginning after December 31, 2017.



# **RESERVE FOR REVENUE-NEUTRAL BUSINESS TAX REFORM**

---

The President is calling on the Congress to immediately begin work on individual and business tax reform that contributes to deficit reduction and increases the incentive to create jobs in the United States. The President laid out a framework for business tax reform that contains the following five elements: (1) Eliminate loopholes and subsidies, broaden the base and cut the corporate tax rate; (2) Strengthen American manufacturing and innovation; (3) Strengthen the international tax system; (4) Simplify and cut taxes for small businesses; and (5) Restore fiscal responsibility and not add a dime to the deficit. Consistent with this framework, the Administration is offering a detailed set of business proposals that close loopholes and provide incentives for growth in a fiscally responsible manner. The Administration proposes that these proposals be enacted as part of revenue-neutral business tax reform that would also cut the corporate tax rate and fundamentally reform tax incentives. As a result, the net savings from these proposals, which are described below, are not reflected in the budget estimates of receipts and are not counted toward meeting the Administration's deficit reduction goals.

## **INCENTIVES FOR MANUFACTURING, RESEARCH, CLEAN ENERGY, AND INSOURCING AND CREATING JOBS**

### **PROVIDE TAX INCENTIVES FOR LOCATING JOBS AND BUSINESS ACTIVITY IN THE UNITED STATES AND REMOVE TAX DEDUCTIONS FOR SHIPPING JOBS OVERSEAS**

#### **Current Law**

Under current law, there are limited tax incentives for U.S. employers to bring offshore jobs and investments into the United States. In addition, costs incurred to outsource U.S. jobs generally are deductible for U.S. income tax purposes.

#### **Reasons for Change**

On January 11, 2012 the White House released a report that details the emerging trend of "insourcing" and how companies are increasingly choosing to invest in the United States. Updating the numbers in that report shows that real private fixed nonresidential investment has grown by about 24 percent since the fourth quarter of 2009. Since the beginning of 2010, manufacturing employment has risen by about 490,000, while manufacturing production has increased by approximately 4.1 percent on an annualized basis. In addition, continued productivity growth has made the United States more competitive in attracting businesses to invest and create jobs by reducing the relative cost of doing business compared to other countries.

Further progress is possible. The Administration would like to make the United States more competitive in attracting businesses by creating a tax incentive to bring offshore jobs and investments back into the United States. In addition, the Administration would like to reduce the tax benefits that exist under current law for expenses incurred to move U.S. jobs offshore.

#### **Proposal**

The proposal would create a new general business credit against income tax equal to 20 percent of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business. For this purpose, insourcing a U.S. trade or business means reducing or eliminating a trade or business (or line of business) currently conducted outside the U.S. and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. While the creditable costs may be incurred by the foreign subsidiary of the U.S.-based multinational company, the tax credit would be claimed by the U.S. parent company. A similar benefit would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

In addition, to reduce tax benefits associated with U.S. companies' moving jobs offshore, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business. For this purpose, outsourcing a U.S. trade or business means reducing or eliminating a trade or business or line of business currently conducted inside the United States

and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign corporation, no reduction would be allowed for any expenses associated with moving a U.S. trade or business outside the United States.

For purposes of the proposal, expenses paid or incurred in connection with insourcing or outsourcing a U.S. trade or business are limited solely to expenses associated with the relocation of the trade or business and do not include capital expenditures or costs for severance pay and other assistance to displaced workers. The Secretary may prescribe rules to implement the provision, including rules to determine covered expenses.

The proposal would be effective for expenses paid or incurred after the date of enactment.

## **PROVIDE NEW MANUFACTURING COMMUNITIES TAX CREDIT**

### **Current Law**

Under current law, there is no tax incentive directly targeted to investments in communities that do not necessarily qualify as low-income communities, but that have suffered or expect to suffer an economic disruption as a result of a major job loss event, such as a military base closing or manufacturing plant closing.

### **Reasons for Change**

The loss of a major employer can devastate a community, and incentives, including tax incentives, could encourage investments that help such affected communities recover more quickly from the economic disruption.

### **Proposal**

The Administration proposes a new allocated tax credit to support investments in communities that have suffered a major job loss event. For this purpose, a major job loss event occurs when a military base closes or a major employer closes or substantially reduces a facility or operating unit, resulting in a long-term mass layoff. Applicants for the credit would be required to consult with relevant state or local Economic Development Agencies (or similar entities) in selecting those investments that qualify for the credit. The credit could be structured using the mechanism of the New Markets Tax Credit or as an allocated investment credit similar to the Qualifying Advanced Energy Project Credit. The Administration intends to work with Congress to craft the appropriate structure and selection criteria. Similar benefits would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

The proposal would provide about \$2 billion in credits for qualified investments approved in each of the three years, 2014 through 2016.

## **ENHANCE AND MAKE PERMANENT THE RESEARCH AND EXPERIMENTATION (R&E) TAX CREDIT**

### **Current Law**

The R&E tax credit is 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The taxpayer's fixed base percentage generally is the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year. Taxpayers can elect the alternative simplified research credit (ASC), which 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. Under the ASC, 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 ASC applies to all succeeding taxable years unless revoked with the consent of the Secretary.

The R&E tax credit also provides a credit for 20 percent of: (1) basic research payments above a base amount; and (2) all eligible payments to an energy research consortium for energy research.

The R&E tax credit is scheduled to expire on December 31, 2013.

### **Reasons for Change**

The R&E tax credit encourages technological developments that are an important component of economic growth. However, uncertainty about the future availability of the R&E tax credit diminishes the incentive effect of the credit because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. To improve the credit's effectiveness, the R&E tax credit should be made permanent.

Currently, a taxpayer must choose between using an outdated formula for calculating the R&E tax credit that provides a 20-percent credit rate for research spending over a certain base amount related to the business's historical research intensity and the much simpler ASC that provides a 14-percent credit in excess of a base amount based on its recent research spending. Increasing the rate of the ASC to 17 percent would provide an improved incentive to increase research and would make the ASC a more attractive alternative. Because the ASC base is updated annually, the ASC more accurately reflects the business's recent research experience and simplifies the R&E tax credit's computation.

### **Proposal**

The proposal would make the R&E tax credit permanent and increase the rate of the ASC from 14 percent to 17 percent, effective after December 31, 2012.

## **EXTEND CERTAIN EMPLOYMENT TAX CREDITS INCLUDING INCENTIVES FOR HIRING VETERANS**

### **Current Law**

The work opportunity tax credit (WOTC) and the Indian employment credit provide temporary tax incentives to employers of individuals from certain targeted groups. The WOTC does not apply to an individual who begins work after December 31, 2013. The Indian employment credit does not apply for tax years beginning after December 31, 2013. Each credit is a component of the general business credit.

The WOTC is available for employers hiring individuals from one or more of nine targeted groups. Current WOTC targeted groups include qualified: (1) recipients of Temporary Assistance for Needy Families; (2) veterans; (3) ex-felons, (4) residents of an empowerment zone or a rural renewal community who are at least 18 but not yet 40 years old; (5) referrals from state-sponsored vocational rehabilitation programs for the mentally and physically disabled; (6) summer youth employees ages 16 or 17 years old residing in an empowerment zone; (7) Supplemental Nutrition Assistance Program benefits recipients at least 18 years old but not yet 40 years old; (8) Supplemental Security Income recipients; and (9) long-term family assistance recipients.

The WOTC is equal to 40 percent (25 percent for employment of 400 hours or less) of qualified wages paid during the first year of employment with a business (i.e., first-year wages). Qualified first-year wages are capped at the first \$3,000 for summer youth employees, \$10,000 for long-term family assistance recipients, \$12,000 for disabled veterans, \$14,000 for long-term unemployed veterans, \$24,000 for long-term unemployed veterans who are also disabled, and \$6,000 for all other categories of targeted individuals. In addition, the first \$10,000 of qualified second-year wages paid to long-term family assistance recipients is eligible for a 50-percent credit. The employer's deduction for wages is reduced by the amount of the credit. The WOTC is allowed to fully offset alternative minimum tax liability.

Qualified wages are those wages subject to the Federal Unemployment Tax Act, without regard to any dollar limitation in section 3306(b), paid by the employer to a member of a targeted group. Individuals must be certified by a designated local agency as a member of a targeted group. The WOTC shall not apply to wages paid to individuals who work fewer than 120 hours in the first year of service.

The WOTC is generally not available to qualified tax-exempt organizations, except for those employing qualified veterans. A qualified tax-exempt organization means an employer that is described in section 501(c) and exempt from tax under section 501(a). A credit of 26 percent (16.25 percent for employment of 400 hours or less) of qualified first-year wages is allowed against the Federal Insurance Contributions Act taxes of the organization.

The Indian employment credit is equal to 20 percent of the excess of qualified wages and health insurance costs paid or incurred by an employer in the current tax year over the amount of such wages and costs paid or incurred by the employer in calendar year 1993. Qualified wages means



wages paid or incurred by an employer for services performed by a qualified employee. Qualified wages shall not include any wages taken into account in determining the WOTC. Qualified employee health insurance costs means any amount paid or incurred by an employer for health insurance coverage for an employee while the employee is a qualified employee. Qualified wages and health insurance costs with respect to any employee for the taxable year may not exceed \$20,000. The employer's deduction for wages is reduced by the amount of the credit.

A qualified employee is an individual who is an enrolled member of an Indian tribe (or is the spouse of an enrolled member), lives on or near the reservation where he or she works, performs services that are substantially all within the Indian reservation, and receives wages from the employer that are less than or equal to \$30,000 (adjusted annually for inflation after 1994) when determined at an annual rate. The inflation adjusted wage limit is \$45,000 for 2013. The credit is not available for employees involved in certain gaming activities or who work in a building that houses such activities.

### **Reasons for Change**

The Indian employment credit was originally enacted in 1993 and the WOTC was originally enacted in 1996, both on a temporary basis. Both credits have been extended numerous times, but extension has often been retroactive or near the expiration date. This pattern leads to uncertainty for employers regarding the availability of the credit and may limit the incentive the credits provide for employers to employ individuals from the targeted groups. To improve the effectiveness of the credits, both credits should be made permanent.

The Indian employment credit is structured as an incremental credit where current year qualified wages and health insurance costs in excess of such costs paid in the base year (1993), are subject to the credit. Updating the base year would eliminate the need for taxpayers to maintain tax records long beyond the normal requirements, and would restore the original incremental design of the credit.

### **Proposal**

The proposal would permanently extend the WOTC to apply to wages paid to qualified individuals who begin work for the employer after December 31, 2013.

The proposal would permanently extend the Indian employment credit to apply to wages paid to qualified employees in tax years beginning after December 31, 2013. In addition, the proposal would modify the calculation of the credit. For tax years beginning after December 31, 2013, the credit would be equal to 20 percent of the excess of qualified wages and health insurance costs paid or incurred by an employer in the current tax year over the amount of such wages and costs paid or incurred by the employer in the base year. The base year costs would equal the average of such wages and costs for the two tax years prior to the current tax year.

## **PROVIDE A TAX CREDIT FOR THE PRODUCTION OF ADVANCED TECHNOLOGY VEHICLES**

### **Current Law**

A tax credit is allowed for plug-in electric drive motor vehicles. A plug-in electric drive motor vehicle is a vehicle that has at least four wheels, is manufactured for use on public roads, is treated as a motor vehicle for purposes of title II of the Clean Air Act (that is, is not a low-speed vehicle), has a gross vehicle weight of less than 14,000 pounds, meets certain emissions standards, draws propulsion energy using a traction battery with at least four kilowatt hours of capacity, is capable of being recharged from an external source, and meets certain other requirements. The credit is \$2,500 plus \$417 for each kilowatt hour of battery capacity in excess of four kilowatt hours, up to a maximum credit of \$7,500. The credit phases out for a manufacturer's vehicles over four calendar quarters beginning with the second calendar quarter following the quarter in which 200,000 of the manufacturer's credit-eligible vehicles have been sold. The credit is generally allowed to the taxpayer that places the vehicle in service (including a person placing the vehicle in service as a lessor). In the case of a vehicle used by a tax-exempt or governmental entity, however, the credit is allowed to the person selling the vehicle to the tax-exempt or governmental entity, but only if the seller clearly discloses the amount of the credit to the purchaser.

### **Reasons for Change**

In 2008, the President set a goal of putting 1 million advanced technology vehicles on the road by 2015 – which would reduce dependence on foreign oil and lead to a reduction in oil consumption of about 750 million barrels through 2030. To help achieve that goal, the President is proposing increased investment in research and development and a competitive program to encourage communities to invest in the advanced vehicle infrastructure, address the regulatory barriers, and provide the local incentives to achieve deployment at critical mass. The President is also proposing a transformation of the existing tax credit for plug-in electric drive motor vehicles into one that is allowed for a wider range of advanced technologies and that is allowed generally to the seller.

Making the credit available to a wider range of technologies, removing the cap placed on the number of vehicles per manufacturer that can receive the credit, and allowing for a scalable credit up to a maximum of \$10,000 will help increase production of advanced vehicles that diversify our fuel use and bring down the cost of producing such vehicles. Moving eligibility for the credit from the purchaser to the person that sells or finances the sale of the vehicle to the ultimate owner would enable the seller or person financing the sale to offer a point-of-sale rebate to consumers. Disclosure requirements, similar to those currently applicable in the case of sales to tax-exempt and governmental entities, would help ensure that the benefit of the credit is passed on to consumers. Shifting the process of claiming the credit from a large number of individual consumers to a relatively small number of business entities would also simplify tax preparation for individuals and reduce the potential for taxpayer error.

## **Proposal**

The proposal would replace the credit for plug-in electric drive motor vehicles with a credit for advanced technology vehicles. The credit would be available for a vehicle that meets the following criteria: (1) the vehicle operates primarily on an alternative to petroleum; (2) as of January 1, 2012, there are few vehicles in operation in the U.S. using the same technology as such vehicle; and (3) the technology used by the vehicle exceeds the footprint based target miles per gallon gasoline equivalent (MPGe) by at least 25 percent. The Secretary of the Treasury, in consultation with the Secretary of Energy, will determine what constitutes the “same technology” for this purpose. The credit would be limited to vehicles that weigh no more than 14,000 pounds and are treated as motor vehicles for purposes of title II of the Clean Air Act. In general, the credit would be the product of \$5,000 and 100 and the amount by which the vehicle’s footprint gallons per mile exceeds its gallons per mile, but would be capped at \$10,000 (\$7,500 for vehicles with an MSRP above \$45,000). The credit for a battery-powered vehicle would be determined under current law rules for the credit for plug-in electric drive motor vehicles if that computation results in a greater credit. The credit would be allowed to the person that sold the vehicle to the person placing the vehicle in service (or, at the election of the seller, to the person financing the sale), but only if the amount of the credit is disclosed to the purchaser.

The credit would be allowed for vehicles placed in service after December 31, 2013 and before January 1, 2021. The credit would be limited to 75 percent of the otherwise allowable amount for vehicles placed in service in 2018, to 50 percent of such amount for vehicles placed in service in 2019, and to 25 percent of such amount for vehicles placed in service in 2020.

## **PROVIDE A TAX CREDIT FOR MEDIUM- AND HEAVY-DUTY ALTERNATIVE-FUEL COMMERCIAL VEHICLES**

### **Current Law**

A tax credit is allowed for fuel-cell vehicles purchased before 2015. The credit is \$20,000 for vehicles weighing more than 14,000 pounds but not more than 26,000 pounds and \$40,000 for vehicles weighing more than 26,000 pounds. There is no other tax incentive for vehicles weighing more than 14,000 pounds.

### **Reasons for Change**

Currently, medium- and heavy-duty trucks consume more than two million barrels of oil every day and account for 20 percent of greenhouse gas emissions related to transportation. Most of these vehicles are powered by diesel fuel. Alternative-fuel vehicles have the potential to reduce petroleum consumption and greenhouse gas emissions. A tax credit would encourage the purchase of such vehicles and the development of a commercially viable manufacturing base for alternative-fuel medium and heavy-duty vehicles.

### **Proposal**

The proposal would allow a tax credit for dedicated alternative-fuel vehicles weighing more than 14,000 pounds. The credit would be equal to 50 percent of the incremental cost of such vehicles compared to the cost of a comparable diesel or gasoline vehicle. The credit would be limited to \$25,000 for vehicles weighing up to 26,000 pounds and \$40,000 for vehicles weighing more than 26,000 pounds. In the case of fuel-cell vehicles, the proposed credit would be reduced by the amount of the credit allowed with respect to the vehicle under current law. The credit would be allowed to the person placing the vehicle in service or, in the case of a vehicle placed in service by a tax-exempt or governmental entity, to the person that sold the vehicle to such entity (or, at the election of the seller, to the person financing the sale), but only if the amount of the credit is disclosed to the purchaser.

The credit would be allowed for vehicles placed in service after December 31, 2013, and before January 1, 2020. For vehicles placed in service in calendar year 2019, the credit would be limited to 50 percent of the otherwise allowable amount.

## **MODIFY AND PERMANENTLY EXTEND RENEWABLE ELECTRICITY PRODUCTION TAX CREDIT**

### **Current Law**

The general business tax credit includes a renewable electricity production tax credit, which is a credit (indexed annually for inflation) per kilowatt-hour of electricity produced from qualified energy facilities. Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy.

The base amount of the electricity production credit is 1.5 cents (indexed annually for inflation) per kilowatt-hour of electricity produced. The amount of the credit was 2.2 cents per kilowatt-hour for 2012. The electricity must be sold to an unrelated third party and a taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, trash combustion facilities, qualified hydropower facilities, and marine and hydrokinetic renewable energy facilities, the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (1.1 cent per kilowatt-hour for 2012).

For all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. In the case of closed-loop biomass facilities modified to co-fire with coal and/or other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits. Construction of a qualified facility must begin before the end of 2013 for the facility to be eligible for the renewable electricity production tax credit.

The general business credit also includes an investment tax credit for energy property. Energy property is (1) property that is part of a facility that, but for the election to claim an investment tax credit, would qualify for the renewable electricity production tax credit and (2) certain other listed property (including solar energy property). In the case of property that is part of a facility that would qualify for the renewable electricity production credit, construction of the facility must begin before the end of 2013 for the facility to be eligible to elect to claim the investment credit. Other listed property (including solar energy property) eligible for the energy investment credit must be placed in service before January 1, 2017.

### **Reasons for Change**

Investments in property qualifying for the renewable electricity production tax credit and the investment tax credit for energy property further the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting greenhouse gas pollution. The extension of incentives for these investments is necessary to the continued success of that policy.

In addition, many renewable developers have insufficient income tax liability to claim the renewable electricity production tax credits and must enter into joint ventures or other financing transactions with other firms in order to take advantage of them. Making the credits refundable will reduce transaction costs, thereby increasing the incentives for firms to produce clean renewable energy. Extending this policy permanently will provide certainty for business planning.

### **Proposal**

The proposal would permanently extend the renewable electricity production tax credit and make it refundable. In addition, the 1.5 cents (indexed annually for inflation) per kilowatt-hour production tax credit would be made available to electricity produced from solar facilities. The refundable tax credit would be available for property on which construction begins after December 31, 2013.

## **MODIFY AND PERMANENTLY EXTEND THE DEDUCTION FOR ENERGY-EFFICIENT COMMERCIAL BUILDING PROPERTY**

### **Current Law**

Taxpayers are allowed to deduct expenditures for energy efficient commercial building property. Energy efficient commercial building property is defined as property (1) which is installed on or in any building that is located in the United States and is within the scope of Standard 90.1-2001, (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001, and (4) with respect to which depreciation (or amortization in lieu of depreciation) is allowable. Standard 90.1-2001, as referred to here, is Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (ASHRAE/IESNA) as in effect on April 2, 2003 – a nationally accepted building energy code that has been adopted by State and local jurisdictions throughout the United States; new editions of the standard are reviewed by the Department of Energy under section 304 of the Energy Conservation and Production Act (P.L. 94-385). The maximum allowable deduction with respect to a building for all tax years is limited to \$1.80 per square foot.

In the case of a building that does not achieve a 50 percent energy savings, a partial deduction is allowed with respect to each separate building system (interior lighting; heating, cooling, ventilation, and hot water; and building envelope) that meets the system-specific energy-savings target prescribed by the Secretary of the Treasury. The applicable system-specific savings targets are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system-specific target. The maximum allowable deduction for each separate system is \$0.60 per square foot.

The deduction is allowed in the year in which the property is placed in service. If the energy efficient commercial building property expenditures are made by a Federal, State, or local government or a political subdivision thereof, the deduction may be allocated to the person primarily responsible for designing the property. The deduction applies to property placed in service on or before December 31, 2013.

### **Reasons for Change**

The President has called for a new Better Buildings Initiative that would reduce energy usage in commercial buildings by 20 percent over 10 years. This initiative would catalyze private sector investment to upgrade the efficiency of commercial buildings. Enhancing the current deduction for energy efficient commercial building property – which is primarily used by taxpayers constructing new buildings – and allowing a new deduction based on the energy savings performance of commercial building property installed in existing buildings would encourage private sector investments in energy efficiency improvements.

## **Proposal**

The proposal would raise the current maximum deduction for energy efficient commercial building property to \$3.00 per square foot. The maximum partial deduction allowed with respect to each separate building system would be increased to \$1.00 per square foot. For taxpayers that simultaneously satisfy the energy savings targets for both building envelope and heating, cooling, ventilation, and hot water systems, the proposal would increase the maximum partial deduction to \$2.20 per square foot. Energy-savings targets would be updated every three years by the Secretary of Treasury in consultation with the Secretary of Energy to encourage innovation by the commercial building industry.

The proposal also would provide a new deduction based on a combination of the projected and realized energy savings performance achieved by a plan to retrofit existing commercial buildings. The deduction would only be applicable to existing buildings with at least 10 years of occupancy. The deduction would be capped at 50 percent of the total cost of implementing the plan. The deduction would be allowed on a sliding scale ranging from \$1.00 per square foot of retrofit floor area, for energy savings of at least 20 percent, up to \$4.00 per square foot of retrofit floor area, for energy savings of 50 percent or more. Sixty percent of the deduction would be available when the property is placed in service and would be based on the projected energy savings performance of the commercial building retrofit plan. The remaining 40 percent of the allowable deduction would be available at a later point and would be based on actual energy savings performance of the retrofit plan. Actual energy savings would be based on the energy usage of the commercial building after the retrofit plan is complete, as determined by methods and procedures provided by Secretary of Treasury in consultation with Secretary of Energy.

Special rules would be provided to allow the credit to benefit a real estate investment trust or its shareholders.

A taxpayer may only take one deduction for each commercial building property.

The deduction would be available for property placed in service after December 31, 2013.



## **TAX RELIEF FOR SMALL BUSINESS**

### **EXTEND INCREASED EXPENSING FOR SMALL BUSINESS**

#### **Current Law**

Section 179 of the Internal Revenue Code provides that, in place of capitalization and depreciation, taxpayers may elect to deduct a limited amount of the cost of qualifying depreciable property placed in service during a taxable year. The deduction limit is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds a specified threshold amount. The maximum deduction amount and the beginning of the phase-out range have been adjusted several times in recent years. For qualifying property placed in service in taxable years beginning in 2007, the maximum deduction amount was \$125,000, but this level was reduced by the amount that a taxpayer's qualifying investment exceeded \$500,000. These two amounts were to have been indexed for inflation in subsequent years (2008-2010). For taxable years 2008 and 2009, however, the maximum deduction was changed to \$250,000, with the phase-out beginning at \$800,000 of qualifying investment, and for 2010 and 2011, these amounts were changed to \$500,000 and \$2 million, respectively. The American Taxpayer Relief Act of 2012 continued the 2011 amounts through 2013. For qualifying property placed in service in taxable years beginning after 2013, the limits will revert to pre-2003 law, with \$25,000 as the maximum deduction and \$200,000 as the beginning of the phase-out range, with no indexing for inflation.

Qualifying property is defined generally as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. However, only \$25,000 of the cost of any sport utility vehicle may be taken into account. For taxable years beginning after 2002 and before 2014, off-the-shelf computer software is considered qualifying property. For taxable years 2010 through 2013, the definition of qualifying property also includes certain real property, such as leasehold improvement property, restaurant property and retail improvement property, but the maximum amount of the cost of such real property that may be expensed is \$250,000.

The amount allowed as a deduction for any taxable year cannot exceed the taxable income of the taxpayer (computed without regard to the section 179 deduction) that is derived from the active conduct of a trade or business for that taxable year. Deductions disallowed because of this limitation may be carried forward to the following taxable year, except that disallowed amounts allocated to real property investments may not be carried over to a taxable year beginning after 2013.

A section 179 election is currently revocable by the taxpayer with respect to any property, but such revocation, once made, is irrevocable. However, an election made with respect to a taxable year beginning after 2013 will not be revocable, except with the consent of the Secretary.

#### **Reasons for Change**

Making permanent the section 179 limits in effect for 2010 through 2013 would achieve several goals. It would provide stability for business planning. By expensing capital purchases, it would

reduce the after-tax cost relative to the claiming of regular depreciation deductions and would encourage greater investment activity (and, thus, greater job creation) by small businesses and entrepreneurs. It would provide simplification for many small businesses by allowing them to avoid the complexity of tracking depreciation. It would provide significant tax relief to America's small businesses and entrepreneurs.

### **Proposal**

The proposal would permanently extend the 2013 section 179 expensing and investment limitations. The deduction limit of \$500,000 and the \$2 million level for beginning the phase-out would be indexed for inflation for all taxable years beginning after 2013, as would the dollar limitation on the expensing of sport utility vehicles. Qualifying property would permanently include off-the-shelf computer software, but would not include real property. An election under section 179 would be revocable by the taxpayer with respect to any property, but such revocation, once made, would be irrevocable.

The proposal would be effective for qualifying property placed in service in taxable years beginning after December 31, 2013.

## **ELIMINATE CAPITAL GAINS TAXATION ON INVESTMENTS IN SMALL BUSINESS STOCK**

### **Current Law**

Under the Small Business Jobs Act of 2010, section 1202 was amended so that taxpayers other than corporations may exclude 100 percent of the gain from the sale of “qualified small business stock” acquired after September 27, 2010 and before January 1, 2011, and held for at least five years, provided various requirements are met. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended this 100-percent exclusion to eligible stock acquired before January 1, 2012, and the American Tax Relief Act of 2012 further extended the 100-percent exclusion to eligible stock acquired before January 1, 2014. The excluded gain is not a preference under the Alternative Minimum Tax (AMT) for eligible stock acquired after September 27, 2010 and before January 1, 2014.

Prior law provided a 50-percent exclusion (60-percent for certain empowerment zone businesses) for qualified small business stock. The taxable portion of the gain is taxed at a maximum rate of 28 percent. The AMT treats 28 percent of the excluded gain on eligible stock acquired after December 31, 2000 and 42 percent of the excluded gain on stock acquired before January 1, 2001 as a tax preference. A 75-percent exclusion enacted under the American Recovery and Reinvestment Act of 2009 applies to qualified stock acquired after February 17, 2009, and before September 28, 2010 with 21 percent of the excluded gains subject to the AMT.

The maximum amount of gain eligible for the exclusion by a taxpayer with respect to any single corporation during any year is the greater of (1) ten times the taxpayer’s basis in stock issued by the corporation and disposed of during the year, or (2) \$10 million reduced by gain excluded in prior years on dispositions of the corporation’s stock. To qualify as a “small business,” the corporation, when the stock is issued, may not have gross assets exceeding \$50 million (including the proceeds of the newly issued stock) and must be a C corporation.

The corporation also must meet certain active trade or business requirements. For example, the corporation must be engaged in a trade or business other than: one 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 the trade or business is the reputation or skill of one or more employees; a banking, insurance, financing, leasing, investing or similar business; a farming business; a business involving production or extraction of items subject to depletion; or a hotel, motel, restaurant, or similar business. There are limits on the amount of real property that may be held by a qualified small business, and ownership of, dealing in, or renting real property is not treated as an active trade or business.

A related provision, section 1045, allows investors that sell qualified small business stock held over six months to defer recognition of capital gain by reinvesting the sales proceeds in new qualified stock within 60 days. Under this rollover provision, the investor’s basis in the new stock is reduced by the amount of the deferred gain.

## **Reasons for Change**

Making the exclusion for small business stock gain permanent would encourage and reward new investment in qualified small business stock. However, treatment of a percentage of excluded gain as a preference under the AMT eliminates almost all of the benefit of the provision for investments made before February 18, 2009. In addition, the current 60-day rollover period under section 1045 for reinvesting proceeds from the sale of qualified small business stock is inadequate. Increasing the rollover period for reinvestment would increase the use of this provision and increase the supply of investment capital for small business.

## **Proposal**

The proposal would make the 100-percent exclusion for qualified small business stock permanent. The AMT preference item for gain excluded under section 1202 would be repealed for all excluded gain on qualified small business stock. In addition to the current 60-day rollover period under section 1045, a new six month rollover period is proposed for taxpayers to reinvest the proceeds from sales of qualified small business stock held longer than three years. Other limitations on the section 1202 exclusion would continue to apply. The proposal would include additional information reporting requirements to assure compliance with those limitations, and taxpayers would be required to report qualified sales on their tax returns.

The proposal would be effective for qualified small business stock acquired after December 31, 2013.

## **DOUBLE THE AMOUNT OF EXPENSED START-UP EXPENDITURES**

### **Current Law**

Start-up expenditures under section 195 consist of any amount (other than interest, taxes, or research and experimental expenditures) that would be deductible if paid or incurred in connection with the operation of an existing active trade or business, but which is instead incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

In general, a taxpayer is not allowed to deduct start-up expenditures other than as a loss upon disposition of the relevant trade or business. However, 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, and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the active trade or business begins. The \$5,000 amount is reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceed \$50,000.

In the case of a taxable year beginning in 2010, the Small Business Jobs Act of 2010 increased the \$5,000 limit on expensed start-up expenditures to \$10,000, where that amount was reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceeded \$60,000.

Under final Treasury regulations, a taxpayer is deemed to have made the election to expense and amortize its start-up expenditures. However, the taxpayer can choose to forgo the deemed election by affirmatively electing to capitalize its start-up expenditures on a timely filed tax return for the taxable year in which the relevant active trade or business begins. The election to amortize or capitalize start-up expenditures for an active trade or business is irrevocable and applies to all start-up expenditures related to that active trade or business.

### **Reasons for Change**

A larger immediate deduction of start-up expenditures lowers the tax cost of investigating new business opportunities and investing in new business activities. Increasing the dollar limit on expensed start-up expenditures would provide a stimulus to business formation and job creation.

### **Proposal**

The Administration proposes to permanently double, from \$5,000 to \$10,000, the maximum amount of start-up expenditures that a taxpayer may deduct (in addition to amortized amounts) in the taxable year in which a trade or business begins. This maximum amount of expensed start-up expenditures would be reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceed \$60,000.

The proposal would be effective for taxable years ending on or after the date of enactment.

## **EXPAND AND SIMPLIFY THE TAX CREDIT PROVIDED TO QUALIFIED SMALL EMPLOYERS FOR NON-ELECTIVE CONTRIBUTIONS TO EMPLOYEE HEALTH INSURANCE**

### **Current Law**

The cost to an employer of providing health coverage for its employees is generally deductible as an ordinary and necessary business expense for employee compensation. In addition, the value of employer-provided health coverage is not subject to employer-paid Federal Insurance Contributions Act tax.

Employees are generally not taxed on the value of employer-provided health coverage for themselves, their spouses and their dependents under an accident or health plan. That is, health coverage benefits are excluded from gross income for purposes of income and employment taxes. Active employees may be able to pay for limited amounts of medical care and for their own employee premium contributions on a pre-tax basis through a cafeteria plan.

The Affordable Care Act created a tax credit to help small employers provide health insurance for employees and their families. An employer must make uniform contributions of at least 50 percent of the premium to qualify for the credit. For taxable years beginning in 2010 through 2013, the credit is available for any health insurance coverage purchased from an insurance company licensed under State law. For taxable years beginning after December 31, 2013, the credit is available only for health insurance purchased through an Affordable Insurance Exchange and only for a maximum coverage period of two additional consecutive taxable years, beginning with the first year in which the employer or any predecessor first offers any qualified plans to its employees through an Exchange.

For-profit firms may claim the tax credit as a general business credit and may carry the credit back for one year and carry the credit forward for 20 years. The credit is available for tax liability under the alternative minimum tax. For tax-exempt organizations, the credit is refundable and is capped at the amount of income tax withholding for employees and both the employee and employer portion of the health insurance (Medicare) payroll tax.

A qualified employer is an employer with no more than 25 full-time equivalent employees during the taxable year and whose employees have annual full-time equivalent wages that average no more than \$50,000 (indexed beginning 2014).

During 2010 through 2013, the maximum credit is 35 percent (25 percent for tax-exempt employers) of the employer's contributions to the premium. For 2014 and later years, the maximum credit percentage is 50 percent (35 percent for tax-exempts). Eligible employer contributions are limited by the amount the employer would have contributed under the State average premium. For example, an employer located in Virginia paying for 60 percent of a single plan costing \$5,500 per year could claim no more than 60 percent of Virginia's average premium of \$4,890 in qualified employer contributions for purposes of calculating the credit.

The credit is phased out on a sliding scale between 10 and 25 full-time equivalent employees as well as between an average annual wage of \$25,000 (indexed) and \$50,000 (indexed). Because the reductions are additive, an employer with fewer than 25 full-time employees paying an average wage less than \$50,000 might not be eligible for any tax credit. For example, an employer with 18 full-time equivalent employees and an average annual wage of \$37,500 would have its credit reduced first by slightly more than half for the phase-out based on the number of employees and then by an additional half for the phase-out based on the average wage, thereby eliminating the entire credit.

### **Reasons for Change**

Expanding eligibility for the credit and simplifying its operation would increase the utilization of the tax credit, and encourage more small employers to provide health benefits to employees and their families. The credit also provides an incentive for small employers to join an Exchange, thereby broadening the risk pool.

The current law denial of the credit to otherwise eligible small employers due to the additive nature of the credit phase-outs may be perceived to be unfair. In addition, the uniform contribution requirement and the State premium contribution limit add complexity and may discourage some small employers from taking advantage of the credit.

### **Proposal**

The proposal would expand the group of employers who are eligible for the credit to include employers with up to 50 full-time equivalent employees and would begin the phase-out at 20 full-time equivalent employees. In addition, there would be a change in the coordination of the phase-outs based on average wage and the number of employees (using a formula that is multiplicative rather than additive) so as to provide a more gradual combined phase-out. As a result, the proposal would ensure that employers with fewer than 50 employees and an average wage less than \$50,000 would be eligible for the credit, even if they are nearing the end of both phase-outs. The proposal would also eliminate the requirement that an employer make a uniform contribution on behalf of each employee (although applicable nondiscrimination laws will still apply), and would eliminate the limit imposed by the State average premium.

The proposal would be effective for taxable years beginning after December 31, 2012.



## **INCENTIVES TO PROMOTE REGIONAL GROWTH**

### **EXTEND AND MODIFY THE NEW MARKETS TAX CREDIT (NMTC)**

#### **Current Law**

The NMTC is a 39-percent credit for qualified equity investments (QEIs) made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE) and is held for a period of seven years. The allowable credit amount for any given year is the applicable percentage (5 percent for the year the equity interest is purchased from the CDE and for each of the two subsequent years, and 6 percent for each of the following four years) of the amount paid to the CDE for the investment at its original issue. The NMTC is available for a taxable year to the taxpayer who holds the QEI on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. 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 ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

Under current law, the NMTC can be used to offset regular federal income tax liability but cannot be used to offset alternative minimum tax (AMT) liability.

The NMTC will expire on December 31, 2013.

#### **Reasons for Change**

Permanent extension of the NMTC would allow CDEs to continue to generate investments in low-income communities. This would also create greater certainty for planning purposes.

#### **Proposal**

The proposal would extend the NMTC permanently, with an allocation amount of \$5 billion for each round. The Administration estimates that \$250 million per round will support financing healthy food options in distressed communities as part of the Healthy Food Financing Initiative. The proposal also would permit NMTC amounts resulting from QEIs made after December 31, 2012, to offset AMT liability.

The proposal would be effective upon enactment.

## **RESTRUCTURE ASSISTANCE TO NEW YORK CITY, PROVIDE TAX INCENTIVES FOR TRANSPORTATION INFRASTRUCTURE**

### **Current Law**

The Job Creation and Worker Assistance Act of 2002 (the Act) provided tax incentives for the area of New York City damaged or affected by the terrorist attacks on September 11, 2001. The Act created the “New York Liberty Zone,” defined as the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. New York Liberty Zone tax incentives included: (1) an expansion of the work opportunity tax credit (WOTC) for New York Liberty Zone business employees; (2) a special depreciation allowance for qualified New York Liberty Zone property; (3) a five-year recovery period for depreciation of qualified New York Liberty Zone leasehold improvement property; (4) \$8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property; (5) \$9 billion of additional tax-exempt, advance refunding bonds; (6) increased section 179 expensing; and (7) an extension of the replacement period for nonrecognition of gain for certain involuntary conversions.<sup>1</sup>

The expanded WOTC credit provided a 40-percent subsidy on the first \$6,000 of annual wages paid to New York Liberty Zone business employees for work performed during 2002 or 2003.

The special depreciation allowance for qualified New York Liberty Zone property equals 30 percent of the adjusted basis of the property for the taxable year in which the property was placed in service. Qualified nonresidential real property and residential rental property must have been purchased by the taxpayer after September 10, 2001, and placed in service before January 1, 2010. Such property is qualified property only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the September 11, 2001, terrorist attacks.<sup>2</sup>

The five-year recovery period for qualified leasehold improvement property applied, in general, to buildings located in the New York Liberty Zone if the improvement was placed in service after September 10, 2001, and before January 1, 2007, and no written binding contract for the improvement was in effect before September 11, 2001.

The \$8 billion of tax-exempt private activity bond financing is authorized to be issued by the State of New York or any political subdivision thereof after March 9, 2002, and before January 1, 2014.

The \$9 billion of additional tax-exempt, advance refunding bonds was available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

---

<sup>1</sup> The Working Families Tax Relief Act of 2004 amended certain New York Liberty Zone provisions relating to tax-exempt bonds.

<sup>2</sup> Other qualified property must have been placed in service prior to January 1, 2007.

Businesses were allowed to expense the cost of certain qualified New York Liberty Zone property placed in service prior to 2007, up to an additional \$35,000 above the amounts generally available under section 179. In addition, only 50 percent of the cost of such qualified New York Liberty Zone property counted toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the replacement period) property similar or related in service or use. In general, the replacement period begins with the date of the disposition of the converted property and ends two years (three years if the converted property is real property held for the productive use in a trade or business or for investment) after the close of the first taxable year in which any part of the gain upon conversion is realized. The Act extended the replacement period to five years for property in the New York Liberty Zone that was involuntarily converted as a result of the terrorist attacks on September 11, 2001, if substantially all of the use of the replacement property is in New York City.

### **Reasons for Change**

Some of the tax benefits that were provided to New York following the attacks of September 11, 2001, likely will not be usable in the form in which they were originally provided. State and local officials in New York have concluded that improvements to transportation infrastructure and connectivity in the Liberty Zone would have a greater impact on recovery and continued development than would continuing some of the original tax incentives.

### **Proposal**

The proposal would provide tax credits to New York State and New York City for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. New York State and New York City each would be eligible for a tax credit for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. The tax credit would be allowed in each year from 2014 to 2023, inclusive, subject to an annual limit of \$200 million (for a total of \$2 billion in tax credits), and would be divided evenly between the State and the City. Any unused credits below the annual limit would be added to the \$200 million annual limit for the following year, including years after 2023. Similarly, expenditures that exceed the annual limit would be carried forward and subtracted from the annual limit in the following year. The credit would be allowed against any payments (other than payments of excise taxes and social security and Medicare payroll taxes) made by the City and State under any provision of the Internal Revenue Code, including income tax withholding. The Treasury Department would prescribe such rules as are necessary to ensure that the expenditures are made for the intended purposes. The amount of the credit received would be considered State and local funds for the purpose of any Federal program.

The proposal would be effective after December 31, 2013.

## **MODIFY TAX-EXEMPT BONDS FOR INDIAN TRIBAL GOVERNMENTS**

### **Current Law**

In general, Section 7871(c) limits Indian tribal governments in their use of tax-exempt bonds to the financing of “essential governmental function” activities that are “customarily” performed by State and local governments with general taxing powers. In addition, outside the limited authorization for Tribal Economic Development Bonds, Section 7871(c)(2) generally prohibits Indian tribal governments from issuing tax-exempt private activity bonds, except in narrow circumstances to finance manufacturing facilities subject to restrictions.

The American Recovery and Reinvestment Act of 2009 (ARRA) provided \$2 billion in bond authority for a new category of tax-exempt bonds for Indian tribal governments, known as “Tribal Economic Development Bonds” under Section 7871(f) of the Internal Revenue Code. This bond provision provides Indian tribal governments more flexibility to finance economic development projects than is allowable under the existing essential governmental function standard. This bond provision generally allows Indian tribal governments to use tax-exempt bond financing under more flexible standards that are comparable to those applied to States and local governments in their use of tax-exempt bonds under Section 103 (subject to express targeting restrictions on Tribal Economic Development Bonds that require financed projects to be located on Indian reservations and that prohibit the financing of certain gaming facilities). For State and local governments, a more flexible two-part standard under Section 141 generally allows use of tax-exempt “governmental bonds” (as distinguished from “private activity bonds”) if either: (1) the issuer uses at least 90 percent of the bond proceeds for State or local governmental use (as contrasted with private business use); or (2) the debt service on at least 90 percent of the bond proceeds is payable from or secured by payments or property used for State or local governmental use.

ARRA also included a directive to the Treasury Department to study the Tribal Economic Development Bond provision and to report to Congress on the results of this study, including recommendations regarding this provision. The legislative history of ARRA indicated that Congress sought recommendations on whether to “eliminate or otherwise modify” the essential governmental function standard for Indian tribal tax-exempt bond financing.

### **Reasons for Change**

In 2011, the Treasury Department submitted its report to Congress regarding recommendations on the Tribal Economic Development Bond provision. This proposal incorporates the recommendations from this report. For further background and analysis on these recommendations, see this Treasury Department report, which is available at <http://www.treasury.gov/resource-center/tax-policy/Documents/Tribal-Economic-Development-Bond-Provision-under-Section-7871-of-IRC-12-19-11.pdf>.

For State and local governments, the applicable two-part private business restriction standard for tax-exempt governmental bonds (as distinguished from private activity bonds) under Section 141 involves established, well-known, and administrable tax standards. The private business use

limitation particularly involves workable tax standards using general tax principles that focus on ownership, leasing, and contractual rights. These standards focus eligibility for governmental bonds on the nature of the beneficiaries of the tax-exempt financing (rather than on the nature of the activities financed).

By contrast, for Indian tribal governments, the essential governmental function standard focuses on appropriate governmental activities (rather than the actual beneficiaries) and has proven to be a difficult standard to define and to administer. The analogous essential governmental function standard under Section 115 is vague. Moreover, the custom-based limitation on this standard has proven to be particularly unworkable, based on difficulties in determining customs, the subjective nature of customs, the evolving nature of customs over time, the differing nature of customs among diverse State and local governmental entities, and the increasing involvement of State and local governments in quasi-commercial activities.

Although the Indian Tribal Government Tax Status Act of 1982 sought to provide tax parity between Indian tribal governments and State and local governments, the existing framework for eligibility for tax-exempt bond financing for State and local governments, on one hand, and Indian tribal governments, on the other hand, reflects fundamentally different analytic standards. Application of the different analytic standards resulted in different outcomes and perceived unfairness.

The Treasury Department believes that goals of tax parity, fairness, flexibility, and administrability warrant the provision of a tax-exempt bond program framework for Indian tribal governments that uses standards that are comparable to those used for State and local governments, with tailored modifications.

### **Proposal**

1. Adopt for Indian Tribal Governments the Comparable State or Local Government Standard of Eligibility for Issuing Tax-exempt Governmental Bonds on a Permanent Basis. The proposal would adopt the State or local government standard for tax-exempt governmental bonds under Section 141 without a bond volume cap on such governmental bonds (subject to restrictions discussed below). This standard is generally embodied in the limited authorization for Tribal Economic Development Bonds under Section 7871(f) for purposes of Indian tribal governmental eligibility to issue tax-exempt governmental bonds. The proposal would repeal the existing essential governmental function standard for Indian tribal governmental tax-exempt bond financing under Section 7871(c).

2. Adopt a Comparable Private Activity Bond Standard. The proposal would allow Indian tribal governments to issue tax-exempt private activity bonds for the same types of projects and activities as are allowed for State and local governments under Section 141(e), under a national bond volume cap. The same volume cap exceptions as those for State and local governments would apply in addition to the bonds being subject to restrictions discussed below. The proposal would employ a tailored version of a comparable annual tax-exempt private activity bond volume cap for Indian tribal governments. This tailored national Tribal private activity bond volume cap for all Indian tribal governments together as a group would be in an amount equal to

the greater of: (i) a total national Indian tribal population-based measure determined under Section 146(d)(1)(A) (applied by using such national Indian tribal population in lieu of State population), or (ii) the minimum small population-based State amount under Section 146(d)(1)(B). The proposal would delegate to the Treasury Department the responsibility to allocate that national bond volume cap among Indian tribal governments.

3. Project Location Restriction. The proposal would impose a targeting restriction on the location of projects financed with tax-exempt bonds issued or used by Indian tribal governments that is similar to the restriction under Section 7871(f)(3)(B)(ii), which requires that projects financed with Tribal Economic Development Bonds be located on Indian reservations. The proposal would provide some additional flexibility with respect to this project location restriction. The proposal would allow Indian tribal governments to issue or use tax-exempt bonds to finance projects that are located on Indian reservations, together with projects that both: (1) are contiguous to, within reasonable proximity of, or have a substantial connection to an Indian reservation; and (2) provide goods or services to resident populations of Indian reservations.

4. Gambling Facility Restriction. For policy reasons, the proposal would impose a targeting restriction on tax-exempt bonds issued or used by Indian tribal governments generally that incorporates the existing targeting restriction under Section 7871(f)(3)(B)(i) which presently prohibits use of proceeds of Tribal Economic Development Bonds to finance certain gaming projects.

The proposal would be effective as of the date of enactment.

## **Reform and Expand the Low-Income Housing Tax Credit**

### **ALLOW STATES TO CONVERT PRIVATE ACTIVITY BOND VOLUME CAP INTO LOW-INCOME HOUSING TAX CREDITS (LIHTCS) THAT THE STATE CAN ALLOCATE**

#### **Current Law**

In general, gross income does not include interest on any State or local bond if the bond is a qualified private activity bond. One of the requirements to be a qualified private activity bond is that the bond generally needs to be part of an issue whose face amount, together with the face amount of other private activity bonds issued by the issuing authority in the calendar year, does not exceed the maximum amount of private activity bonds that the authority may issue for the year (referred to as the “PAB volume cap”). Every year, under the Internal Revenue Code (the Code), each State is allowed a limited amount of PAB volume cap.

Each year, the Code also provides each State with a limited amount of LIHTCs for the State to allocate. In addition to receiving a State allocation of LIHTCs, a building owner can earn LIHTCs by financing the building with qualified private activity bonds. These latter LIHTCs may be earned on the qualified basis of a building if the qualified private activity bonds are subject to the PAB volume cap and they finance at least half of the aggregate basis of the building and the land. In the case of bond-derived credits, however, the credit rate is lower than the credit rate that applies to State-allocated credits.

#### **Reasons for Change**

State housing finance agencies in charge of allocating LIHTCs are often confronted with more deserving projects than they can support. Although bond-derived credits might facilitate the development of some buildings, other buildings can be built only with the higher credit rates that are available with allocated credits. Moreover, issuance of bonds imposes transaction costs, so it may not be economical to use bonds to finance smaller multi-family projects. Increasing the volume of credits that are at a higher rate than bond-derived credits and that do not require issuance of bonds would allow the development of some meritorious projects for which the current supply of higher-rate credits is insufficient.

#### **Proposal**

Under the proposal, States would be authorized to convert PAB volume cap to be received for a calendar year into LIHTC allocation authorization applicable to the same year. The conversion ratio would be reset each calendar year to respond to changing interest rates. In addition, each State would be subject to an annual maximum amount of PAB volume cap that can be converted.

#### *Conversion ratio*

For each \$1,000 of PAB volume cap surrendered, the State would receive additional allocable LIHTCs for the calendar year equal to—

\$1000 × twice the applicable percentage determined under section 42(b)(1)(B)(ii) for December of the preceding calendar year.

*State-by-State limits on annual conversions*

The aggregate amount of PAB volume cap that each State may convert with respect to a calendar year is 7 percent of the PAB volume cap that the State receives for that year under section 146(d)(1).

The proposal would be effective with respect to PAB volume cap to be received in, and additional LIHTC allocation authority received for, calendar years beginning after the date of enactment.



## **ENCOURAGE MIXED INCOME OCCUPANCY BY ALLOWING LOW-INCOME HOUSING TAX CREDIT (LIHTC)-SUPPORTED PROJECTS TO ELECT A CRITERION EMPLOYING A RESTRICTION ON AVERAGE INCOME**

### **Current Law**

In order for a building to qualify for the LIHTC, a minimum portion of the units in the building must be rent restricted and occupied by low-income tenants. Under section 42(g)(1), the taxpayer makes an irrevocable election between two criteria. Either—

- At least 20 percent of the units must be rent restricted and occupied by tenants with income at or below 50 percent of area median income (AMI); or
- At least 40 percent of the units must be rent restricted and occupied by tenants with incomes at or below 60 percent of AMI.

In all cases, qualifying income standards are adjusted for family size. The amount of the credit reflects the fraction of the building's eligible basis that is attributable to the low-income units. Maximum allowable rents are restricted to 30 percent of the elected income standard, adjusted for the number of bedrooms in the unit.

### **Reasons for Change**

In practice, these criteria often produce buildings that serve a very narrow income band of tenants—those just below the top of the eligible income range. For example, if the rent-restricted units in the building must be occupied by tenants at or below 60 percent of AMI, these units may end up being occupied by tenants with incomes that fall between 40 percent and 60 percent of AMI. As a result, the income criteria do not include incentives to create mixed-income housing, and LIHTC-supported buildings may not be able to serve those most in need. Mixed-income buildings are especially important in low-income communities that are being revitalized and in sparsely populated rural areas. In addition, the inflexibility of the income criteria makes it difficult for LIHTC to support acquisition of partially or fully occupied properties for preservation or repurposing.

### **Proposal**

The proposal would add a third criterion to the two described above. When a taxpayer elects this criterion, at least 40 percent of the units in the project would have to be occupied by tenants with incomes that *average* no more than 60 percent of AMI. No rent-restricted unit, however, could be occupied by a tenant with income over 80 percent of AMI; and, for purposes of computing the average, any unit with an income limit that is less than 20 percent of AMI would be treated as having a 20-percent limit. Maximum allowable rents would be determined according to the income limit of the unit.

For example, suppose that a project has 70 identical rent-restricted units—10 units with income limits of 20 percent of AMI, 10 with limits of 40 percent of AMI, 20 with limits of 60 percent of

AMI, and 30 with limits of 80 percent of AMI. This would satisfy the new criterion because none of the limits exceeds 80 percent of AMI and the average does not exceed 60 percent of AMI. ( $10 \times 20 + 10 \times 40 + 20 \times 60 + 30 \times 80 = 4200$ , and  $4200/70 = 60$ .)

A special rule would apply to rehabilitation projects that contain units that receive ongoing subsidies (e.g., rental assistance, operating subsidies, and interest subsidies) administered by the U.S. Department of Housing and Urban Development or the U.S. Department of Agriculture. If a tenant, when admitted to such a property, had an income not more than 60 percent of the then-applicable AMI and if, when the tenant's income is measured for purposes of LIHTC qualification, the tenant's income is greater than 60 percent of the now-applicable AMI but not more than 80 percent of AMI (this fraction is called the "Credit-Year-1 AMI Percentage"), then, the taxpayer may make an election that would allow the tenant to remain in residence without impairing the building's LIHTCs. In particular, the election would have the following consequences—

- The average-income criterion would be applied without taking that tenant's unit into account;
- The requirement in the next-available-unit rule, *see* section 42(g)(2)(D)(ii), would apply; and
- The tenant's unit would be treated as rent restricted if the gross rent collected from the unit does not exceed 30 percent of the Credit-Year-1 AMI Percentage times current AMI.

When the tenant moves out, if the unit is to continue to be rent-restricted, the income restriction on the unit would revert to 60 percent of AMI (or whatever other level the taxpayer determines, consistent with the criterion that was elected under section 42(g)(1)).

The proposal would be effective for elections under section 42(g)(1) that are made after the date of enactment.

## **CHANGE FORMULAS FOR 70 PERCENT PV AND 30 PERCENT PV LOW-INCOME HOUSING TAX CREDITS (LIHTCS)**

### **Current Law**

The owner of rental housing occupied by tenants having incomes below specified levels may claim the LIHTC over a 10-year period. The credits earned each year generally depend on three factors—the investment in the building, the portion of the building devoted to low-income units, and a credit rate (called the “applicable percentage”).

There are two applicable percentages, referred to as the 70-percent present value credit rate and the 30-percent present value credit rate. Each month, the Internal Revenue Service (IRS) announces these rates. The Internal Revenue Code prescribes discount factors and other computational assumptions that the IRS must use in setting the rates. The stated goal of the required computations is to ascertain rates such that the 10 annual installments of the credit have a present value of 70 percent (or 30 percent) of the total qualified basis of the property. (Generally, the qualified basis is the investment in the building, times the fraction of the building devoted to low-income units.)

The Housing and Economic Recovery Act of 2008 provided a temporary minimum applicable percentage of 9 percent for the 70-percent present value credit rate for buildings placed in service before December 31, 2013. The American Taxpayer Relief Act of 2012 extended the 9-percent rate to apply to credit allocations made before January 1, 2014.

Every year, each State receives a limited number of LIHTCs that it may allocate. Most allocated LIHTCs are earned at the 70-percent present value credit rate (or, when applicable, at the 9-percent minimum rate). However, instead of a building owner earning LIHTCs as a result of a State allocation, if the owner uses tax-exempt private activity bonds to finance at least half of the cost of a building (including the land), then the entire qualified basis in the building may earn LIHTCs. These credits are at the 30-percent present value credit rate, and they do not reduce the State’s remaining allocable LIHTCs.

### **Reasons for Change**

Experience has demonstrated that the current discounting formula does not function well when rates are particularly high or low.

For example, when interest rates are very low (as they have been for the last few years) the statutorily prescribed discount rate is very low. As a result, the applicable percentage is determined using an artificially high present value for LIHTCs to be received toward the end of the credit period. This distortion produces applicable percentages that are so low that the LIHTC regime does not operate as Congress originally intended. The low rates prevent States from addressing their highest affordable-housing priorities, which often require relatively high levels of LIHTC subsidy. Moreover, there have been recent reductions in the Federal and State resources that might have filled financing gaps in LIHTC projects. This absence of alternative

subsidies exacerbates the difficulty posed by the too-low discount rate. The temporary 9-percent floor was a response to these challenges.

Similarly, problems appear when interest rates are very high. In high-interest-rate environments, the statutory discount rate produces more accurate present value computations, but the need for LIHTCs is especially acute. LIHTC applicable percentages should be higher to counteract the fact that rising interest rates increase the gap between an owner's expenditures, including especially debt service, and the restricted rents that the LIHTC statute allows the owner to collect.

### **Proposal**

The proposal would allow the 9-percent temporary minimum applicable percentage to expire at the end of 2013 and would increase the discount rate used in the present value calculation for allocated LIHTCs. The new discount rate would better reflect private-market discount rates. The change would apply to both 70 percent and 30 percent allocated LIHTCs. Under the proposal, the discount rate to be used would be the average of the mid-term and long-term applicable Federal rates for the relevant month, plus 200 basis points. (However, the 30-percent present value credit rate for LIHTCs that result from bond financing would continue to be computed under current law.)

The proposal would be effective for allocations made after December 31, 2013.

## **ADD PRESERVATION OF FEDERALLY ASSISTED AFFORDABLE HOUSING TO ALLOCATION CRITERIA**

### **Current Law**

Each State (including State housing finance agencies in charge of allocating low income housing tax credits (LIHTCs)) must adopt a qualified allocation plan (QAP) to guide the allocation of LIHTCs. The Internal Revenue Code prescribes ten selection criteria that every QAP must include. These required criteria are: project location, housing needs characteristics, project characteristics (including whether the project includes the use of existing housing as part of a community revitalization plan), sponsor characteristics, tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project.

### **Reasons for Change**

Preservation and rehabilitation of existing affordable housing is often a more efficient way of supplying affordable housing than is new construction. In addition, public resources may have already been expended in the development of existing affordable housing. Thus, preservation of federally assisted affordable housing should be encouraged.

### **Proposal**

The proposal would add preservation of federally assisted affordable housing as an eleventh selection criterion that QAPs must include.

The proposal would be effective for allocations made in calendar years beginning after the date of enactment.

## **MAKE THE LOW-INCOME HOUSING TAX CREDIT (LIHTC) BENEFICIAL TO REAL ESTATE INVESTMENT TRUSTS (REITS)**

### **Current Law**

REITs and regulated investment companies (RICs) receive no benefit from becoming entitled to a general business credit under section 38, such as the LIHTC. Like other financial intermediaries, REITs and RICs are efficient investment vehicles only if they and their investors together incur only a single level of tax on the income from the REITs' or RICs' investments. The Internal Revenue Code (Code) achieves this result by allowing REITs and RICs a deduction for dividends paid (the DPD). Qualification requirements and an excise tax cause REITs and RICs to pay dividends of substantially all of their pre-DPD net income. In addition, the Code enables each REIT or RIC exactly to zero out its taxable income for the year by paying post-taxable-year-end dividends that the REIT or RIC may nevertheless deduct as if the dividends had been paid during the taxable year. A REIT or RIC that zeroes out its taxable income has no tax liability against which to use a tax credit.

Moreover, their shareholders would receive no benefit from REITs' or RICs' receiving those credits. REITs and RICs are C corporations. That is, unlike trusts, partnerships, and S corporations, they generally do not directly pass through tax items to their owners. A significant number of REIT shares are held by RICs.

The LIHTC provision in the Code encourages construction and major rehabilitation of affordable housing for low-income residents. A taxpayer is eligible to receive LIHTCs only after receiving an allocation either of credits or of tax-exempt volume cap from an appropriate State agency. In almost all financial climates, there are not enough allocations to satisfy all applicants. Although the credits that make up the general business credit are not transferable, in many cases—including LIHTCs—there is, in effect, a “market” for the credits. The value of the credits in this market is reflected in the amount of equity that the credit can attract to the activity that Congress wanted to encourage when it created the credit.

### **Reasons for Change**

The effectiveness of LIHTCs in increasing the construction and preservation of affordable housing would be enhanced if there were more demand for these credits. For example, during the recent economic crisis, there was a sharp drop in the amount that investors were willing to invest for each dollar of LIHTC acquired. If REIT shareholders could benefit from any LIHTCs that REITs receive, there would be an increase in demand.

### **Proposal**

The proposal would permit a REIT that receives LIHTCs to designate as tax exempt some of the dividends that it distributes. Dividends so designated would be excluded from the gross income of the shareholders that receive them. The amount so designated could not exceed the quotient of the REIT's LIHTCs for the year, divided by the highest corporate tax rate in section 11(b) of the Code. If there is insufficient E&P to pay this amount of dividends, the unused authority to

designate tax-exempt dividends could be carried forward indefinitely. Also, if a REIT or RIC is a shareholder that receives these tax-exempt dividends, the recipient could designate as exempt a corresponding amount of dividends that it distributes. In the case of any compliance failure, the REIT would be responsible for recapture under section 42(j) as if it had used the credit to reduce its own tax liability. Under the proposal, the passive-loss and at-risk rules would not apply to the receipt of the exempt dividends.

The proposal would be effective for taxable years of a REIT that end after the date of enactment.

## **REFORM U.S. INTERNATIONAL TAX SYSTEM**

### **DEFER DEDUCTION OF INTEREST EXPENSE RELATED TO DEFERRED INCOME OF FOREIGN SUBSIDIARIES**

#### **Current Law**

Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. The Internal Revenue Code and the regulations thereunder contain detailed rules regarding allocation and apportionment of expenses for computing taxable income from sources within and without the United States. Under current rules, a U.S. person that incurs interest expense properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. For example, a U.S. person that incurs debt to acquire stock of a foreign corporation is generally permitted to deduct currently the interest expense from the acquisition indebtedness even if no income is derived currently from such stock. Current law includes provisions that may require a U.S. person to recapture as U.S.-source income the amount by which foreign-source expenses exceed foreign-source income for a taxable year. However, if in a taxable year the U.S. person earns sufficient foreign-source income of the same statutory grouping in which the stock of the foreign corporation is classified, expenses, such as interest expense, properly allocated and apportioned to the stock of the foreign corporation may not be subject to recapture in a subsequent taxable year.

#### **Reasons for Change**

The ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming the domestic economy.

#### **Proposal**

The proposal would defer the deduction of interest expense that is properly allocated and apportioned to stock of a foreign corporation that exceeds an amount proportionate to the taxpayer's pro rata share of income from such subsidiaries that is currently subject to U.S. tax. Under the proposal, foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax; thus, the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (for example, royalty income) would be similarly treated.

For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to stock of a foreign corporation would generally be determined under the principles of current Treasury regulations. The Treasury Department, however, will continue to revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.



Interest expense that is deferred under the proposal would be deductible in a subsequent tax year to the extent that the amount of interest expense allocated and apportioned to stock of foreign subsidiaries in such subsequent year is less than the annual limitation for that year. Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expenses in certain cases.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **DETERMINE THE FOREIGN TAX CREDIT ON A POOLING BASIS**

### **Current Law**

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under section 902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). The foreign tax credit is limited to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign-source income. This foreign tax credit limitation is applied separately to foreign-source income in each of the separate categories described in section 904(d)(1), i.e., the passive category and general category.

### **Reasons for Change**

The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction to two foreign tax credit limitation categories, for passive category income and general category income under the American Jobs Creation Act of 2004, enhanced U.S. taxpayers' ability to reduce the residual U.S. tax on foreign-source income through "cross-crediting."

### **Proposal**

The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis taking into account the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be limited to an amount proportionate to the taxpayer's pro rata share of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year that are currently subject to U.S. tax. Foreign taxes deferred under this proposal in prior years would be creditable in a subsequent taxable year to the extent that the amount of deemed paid foreign taxes in the current year are less than the annual limitation for that year. The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **TAX CURRENTLY EXCESS RETURNS ASSOCIATED WITH TRANSFERS OF INTANGIBLES OFFSHORE**

### **Current Law**

Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever “necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.” The regulations under section 482 provide that the standard to be applied is that of unrelated persons dealing at arm’s length. In the case of transfers of intangible assets, section 482 further provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets.

In general, the subpart F rules (sections 951-964) require U.S. shareholders with a 10- percent or greater interest in a controlled foreign corporation (CFC) to include currently in income for U.S. tax purposes their pro rata share of certain income of the CFC (referred to as “subpart F income”), without regard to whether the income is actually distributed to the shareholders. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation’s stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the corporation’s voting stock.

Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other proscribed activities. Foreign base company income consists of foreign personal holding company income (which includes passive income such as dividends, interest, rents, royalties, and annuities) and other categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

A foreign tax credit is generally available for foreign income taxes paid by a CFC to the extent that the CFC’s income is taxed to a U.S. shareholder under subpart F, subject to the limitations set forth in section 904.

### **Reasons for Change**

The potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules. There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base. Expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates will reduce the incentive for taxpayers to engage in these transactions.

## **Proposal**

The proposal would provide that if a U.S. person transfers (directly or indirectly) an intangible asset from the United States to a related CFC (a “covered intangible”), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10 percent or less, the proposal would treat all excess income as subpart F income, and would then phase out ratably for effective tax rates of 10 to 15 percent. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. For purposes of this proposal, the transfer of an intangible asset includes by sale, lease, license, or through any shared risk or development agreement (including any cost sharing arrangement)). This subpart F income will be a separate category of income for purposes of determining the taxpayer’s foreign tax credit limitation under section 904.

The proposal would be effective for transactions in taxable years beginning after December 31, 2013.

## **LIMIT SHIFTING OF INCOME THROUGH INTANGIBLE PROPERTY TRANSFERS**

### **Current Law**

Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever “necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.” Section 482 also provides that in the case of transfers of intangible assets, the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets. Further, under section 367(d), if a U.S. person transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in certain nonrecognition transactions, the U.S. person is treated as selling the intangible property for a series of payments contingent on the productivity, use, or disposition of the property that are commensurate with the transferee's income from the property. The payments generally continue annually over the useful life of the property.

### **Reasons for Change**

Controversy often arises concerning the value of intangible property transferred between related persons and the scope of the intangible property subject to sections 482 and 367(d). This lack of clarity may result in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons.

### **Proposal**

The proposal would clarify the definition of intangible property for purposes of sections 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the Commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **DISALLOW THE DEDUCTION FOR NON-TAXED REINSURANCE PREMIUMS PAID TO AFFILIATES**

### **Current Law**

Insurance companies are generally allowed a deduction for premiums paid for reinsurance. If the reinsurance transaction results in a transfer of reserves and reserve assets to the reinsurer, potential tax liability for earnings on those assets is generally shifted to the reinsurer as well. While insurance income of a controlled foreign corporation is generally subject to current U.S. taxation, insurance income of a foreign-owned foreign company that is not engaged in a trade or business in the United States is not subject to U.S. income tax. Reinsurance policies issued by foreign reinsurers with respect to U.S. risks are generally subject to an excise tax equal to one percent of the premiums paid, unless waived by treaty.

### **Reasons for Change**

Reinsurance transactions with affiliates that are not subject to U.S. federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States. The excise tax on reinsurance policies issued by foreign reinsurers is not always sufficient to offset this tax advantage. These tax advantages create an inappropriate incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates.

### **Proposal**

The proposal would (1) deny an insurance company a deduction for premiums and other amounts paid to affiliated foreign companies with respect to reinsurance of property and casualty risks to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) would exclude from the insurance company's income (in the same proportion in which the premium deduction was denied) any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States and attributable to a permanent establishment for tax treaty purposes. For foreign tax credit purposes, reinsurance income treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

The provision would be effective for policies issued in taxable years beginning after December 31, 2013.

## **LIMIT EARNINGS STRIPPING BY EXPATRIATED ENTITIES**

### **Current Law**

Section 163(j) limits the deductibility of certain interest paid by a corporation to related persons. The limitation applies to a corporation that fails a debt-to-equity safe harbor (greater than 1.5 to 1), and that has net interest expense in excess of 50 percent of adjusted taxable income (generally computed by adding back net interest expense, depreciation, amortization and depletion, any net operating loss deduction, and any deduction for domestic production activities under section 199). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In addition, the corporation's excess limitation for a taxable year (i.e., the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent taxable years.

Section 7874 provides special rules for expatriated entities and the acquiring foreign corporations. The rules apply to certain defined transactions in which a U.S. parent company (the expatriated entity) is essentially replaced with a foreign parent (the surrogate foreign corporation). The tax treatment of an expatriated entity and a surrogate foreign corporation varies depending on the extent of continuity of shareholder ownership following the transaction. The surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code if shareholder ownership continuity is at least 80 percent (by vote or value). If shareholder ownership continuity is at least 60 percent, but less than 80 percent, the surrogate foreign corporation is treated as a foreign corporation but certain tax consequences apply, including that any applicable corporate-level income or gain required to be recognized by the expatriated entity generally cannot be offset by tax attributes. Section 7874 generally applies to transactions occurring on or after March 4, 2003.

### **Reasons for Change**

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. In its 2007 study of earnings stripping, the Treasury Department found strong evidence of the use of such techniques by expatriated entities. Consequently, amending the rules of section 163(j) for expatriated entities is necessary to prevent these inappropriate income-reduction opportunities.

### **Proposal**

The proposal would revise section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons. The current law debt-to-equity safe harbor would be eliminated. The 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent. The carryforward for disallowed interest would be limited to ten years, and the carryforward of excess limitation would be eliminated.

An expatriated entity would be defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989. This special rule would not apply, however, if the surrogate foreign corporation is treated as a domestic corporation under section 7874.

The proposal would be effective for taxable years beginning after December 31, 2013.



## **MODIFY TAX RULES FOR DUAL CAPACITY TAXPAYERS**

### **Current Law**

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States.

To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under United States tax principles, regardless of the label attached to the levy under law. Under current Treasury regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive a specific economic benefit from the levying country (dual capacity taxpayers) may not credit the portion of the foreign levy paid for the specific economic benefit. The current Treasury regulations provide that, if a foreign country has a generally-imposed income tax, the dual capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (provided that the levy otherwise constitutes an income tax or an in lieu of tax). The balance of the levy is treated as compensation for the specific economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable federal tax rate applied to net income is treated as a creditable tax. A foreign tax is treated as generally imposed even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit limitation category for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on foreign oil and gas income is limited in any year to the applicable U.S. tax on that income.

### **Reasons for Change**

The purpose of the foreign tax credit is to mitigate double taxation of income by the United States and a foreign country. When a payment is made to a foreign country in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but fails to achieve the appropriate split between the two when a single payment is made in a case where, for example, a foreign country imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income.

### **Proposal**

The proposal would allow a dual capacity taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. The proposal would replace the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax. The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign

oil and gas income. The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would yield to United States treaty obligations to the extent that they explicitly allow a credit for taxes paid or accrued on certain oil or gas income.

The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would be effective for amounts that, if such amounts were an amount of tax paid or accrued, would be considered paid or accrued in taxable years beginning after December 31, 2013. The aspect of the proposal that would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 would be effective for taxable years beginning after December 31, 2013.

## **TAX GAIN FROM THE SALE OF A PARTNERSHIP INTEREST ON LOOK-THROUGH BASIS**

### **Current Law**

In general, the sale or exchange of a partnership interest is treated as the sale or exchange of a capital asset. Capital gains of a nonresident alien individual or foreign corporation generally are subject to federal income tax only if the gains are or are treated as income that is effectively connected with the conduct of a trade or business in the United States (ECI). Section 875(1) provides that a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged. Revenue Ruling 91-32 holds that gain or loss of a nonresident alien individual or foreign corporation from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership's trade or business within the United States (ECI property). A partnership may elect under section 754 to adjust the basis of its assets upon the transfer of an interest in the partnership to reflect the transferee partner's basis in the partnership interest.

### **Reasons for Change**

Nonresident alien individuals and foreign corporations may take a position contrary to the holding of Revenue Ruling 91-32, arguing that gain from the sale of a partnership interest is not subject to federal income taxation because no Internal Revenue Code (Code) provision explicitly provides that gain from the sale or exchange of a partnership interest by a nonresident alien individual or foreign corporation is treated as ECI. If the partnership has in effect an election under section 754, the partnership's basis in its assets is also increased, thereby preventing that gain from being taxed in the future.

### **Proposal**

The proposal would provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

In addition, the transferee of a partnership interest would be required to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. If a transferor provided a certificate from the Internal Revenue Service that established that the transferor's federal income tax liability with respect to the transfer was less than 10 percent of the amount realized, the transferee would withhold such lesser amount. If the transferee failed to

withhold the correct amount, the partnership would be liable for the amount of underwithholding, and would satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

The proposal would be effective for sales or exchanges after December 31, 2013.

## **PREVENT USE OF LEVERAGED DISTRIBUTIONS FROM RELATED FOREIGN CORPORATIONS TO AVOID DIVIDEND TREATMENT**

### **Current Law**

Section 301 provides rules for characterizing a distribution of property by a corporation to a shareholder. The amount of the distribution is first treated as a dividend to the extent of the distributing corporation's applicable earnings and profits. To the extent the amount of the distribution exceeds the distributing corporation's applicable earnings and profits, the excess amount is treated as a reduction in the shareholder's adjusted tax basis in the stock of the distributing corporation, and then any remaining excess is treated by the shareholder as gain from the sale or exchange of property. For these purposes, a corporation generally calculates its earnings and profits on a stand-alone basis, with special rules for consolidated groups.

### **Reasons for Change**

Under current law, the earnings and profits of a foreign corporation can be repatriated without being characterized as a dividend by having such corporation fund a distribution from a second, related foreign corporation that does not have earnings and profits, but in which the distributee shareholder has sufficient tax basis to characterize the distribution (in whole or substantial part) as a return of stock basis under the ordering rules of section 301.

### **Proposal**

The proposal would provide that to the extent a foreign corporation (the "funding corporation") funds a second, related foreign corporation (the "foreign distributing corporation") with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder's basis in the stock of the distributing corporation will not be taken into account for the purpose of determining the treatment of the distribution under section 301. For this purpose, the funding corporation and the foreign distributing corporation are related if they are members of a controlled group within the meaning of section 1563(a), but replacing the reference to "at least 80 percent" with "more than 50 percent." Funding transactions to which the proposal would apply include capital contributions, loans, or distributions to the foreign distributing corporation, whether the funding transaction occurs before or after the distribution.

The proposal would be effective for distributions made after December 31, 2013.

## **EXTEND SECTION 338(h)(16) TO CERTAIN ASSET ACQUISITIONS**

### **Current Law**

A corporation that makes a qualified stock purchase of a target corporation is permitted to elect under section 338 (section 338 election) to treat the stock acquisition as an asset acquisition, thereby stepping up the tax basis of the target corporation's assets. For this purpose, a qualified stock purchase is any transaction or series of transactions in which the purchasing corporation acquires 80 percent of the stock of the target corporation. Section 338(h)(16) provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is not treated as occurring for purposes of determining the source or character of any item for purpose of applying the foreign tax credit rules to the seller. Instead, for these purposes, the gain is generally treated by the seller as gain from the sale of the stock. Thus, section 338(h)(16) prevents a seller from increasing allowable foreign tax credits as a result of a section 338 election.

Section 901(m) denies a credit for certain foreign taxes paid or accrued after a covered asset acquisition (CAA). A CAA includes a section 338 election made with respect to a qualified stock purchase as well as other transactions that are treated as asset acquisitions for U.S. tax purposes but the acquisition of an interest in an entity for foreign tax purposes.

### **Reasons for Change**

Section 338(h)(16) applies to a qualified stock purchase for which a section 338 election is made, but it does not apply to the other types of CAAs subject to the credit disallowance rules under section 901(m). These other types of CAAs present the same foreign tax credit concerns as those addressed by section 338(h)(16) in the case of a qualified stock purchase for which a section 338 election is made.

### **Proposal**

The proposal would extend the application of section 338(h)(16) to any CAA, within the meaning of section 901(m). The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

The proposal would apply to CAAs occurring after December 31, 2013.

## **REMOVE FOREIGN TAXES FROM A SECTION 902 CORPORATION'S FOREIGN TAX POOL WHEN EARNINGS ARE ELIMINATED**

### **Current Law**

Section 902 provides that a domestic corporation owning at least 10 percent of the voting stock of a foreign corporation is allowed a credit for foreign taxes paid by a foreign corporation if the domestic corporation receives a dividend distribution from the foreign corporation or, in certain circumstances, if it has a subpart F income inclusion that is treated as a deemed dividend for purposes of section 902.

Certain transactions result in a reduction, allocation, or elimination of a corporation's earnings and profits other than by reason of a dividend or deemed dividend, or by reason of section 381 (generally providing that earnings and profits and other tax attributes of a target corporation carry over to an acquiring corporation in a tax-free restructuring transaction). For example, if a corporation redeems a portion of its stock and the redemption is treated as a sale or exchange, there is a reduction in the earnings and profits (if any) of the redeeming corporation (see section 312(n)(7)). As another example, certain section 355 distributions can result in the reduction of the distributing corporation's earnings and profits (see section 312(h) and the regulations thereunder).

### **Reasons for Change**

The elimination of earnings and profits without a corresponding reduction in the associated foreign taxes paid results in a taxpayer claiming an indirect credit under section 902 for foreign taxes paid with respect to earnings that will no longer fund a dividend distribution for U.S. tax purposes.

### **Proposal**

The proposal would reduce the amount of foreign taxes paid by a foreign corporation in the event a transaction results in the elimination of a foreign corporation's earnings and profits other than a reduction of earnings and profits by reason of a dividend or deemed dividend, or by reason of a section 381 transaction. The amount of foreign taxes that would be reduced in such a transaction would equal the amount of foreign taxes associated with the eliminated earnings and profits.

The proposal would be effective for transactions occurring after December 31, 2013.

## **REFORM TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS**

### **REQUIRE THAT DERIVATIVE CONTRACTS BE MARKED TO MARKET WITH RESULTING GAIN OR LOSS TREATED AS ORDINARY**

#### **Current Law**

Under current law, derivative contracts are subject to rules on timing and character that vary according to how a contract is characterized and, in some cases, where it is traded. Forward contracts are generally taxable only when they are transferred or settled, with the resulting gain or loss treated as capital. Options are also taxable only when they are transferred, settled, or when the option lapses, with gain or loss treated as capital. When a forward contract is traded on an exchange, however, it is generally classified as a regulated futures contract, which is treated as sold on the last day of the taxable year (marked to market), with gain or loss treated as 60 percent long term and 40 percent short term. Certain exchange traded options are also entitled to 60/40 treatment.

Notional principal contracts (NPCs, also often referred to as swap contracts) are subject to their own timing and character rules. Income and expense from the two legs of a NPC are netted and accrued annually as ordinary income or deduction, as the case may be. In the case of a NPC that provides for one or more contingent nonperiodic payments, however, such as the value of stock on a specified future date, the tax rules are unclear. Gain or loss that results from the sale or termination of a NPC, whether the NPC provides for contingent or non-contingent payments, is generally treated as capital. Different timing and character rules may apply to forwards, options, and NPCs that are qualified hedges, part of a straddle, or referenced to a foreign currency.

In addition to forwards, futures, options, and NPCs, there are contractual arrangements such as convertible debt, contingent debt, structured notes, and securities lending transactions that either are themselves derivatives or contain embedded derivatives. Different timing and character rules also apply to these instruments. Contingent debt, for example, requires the holder to accrue current income based on the payments the holder would receive from a comparable noncontingent bond of the issuer, with adjustments required for payments that differ from the projected payment schedule. Both income and gain from a contingent debt instrument is generally ordinary. In the case of a structured note (which includes many exchange traded notes), the tax rules are unclear. Structured note holders generally take the view that no income or gain is required until the structured note matures or is sold, and they treat the gain or loss as capital. Similarly, taxpayers that enter into a securities lending transaction have disposed of their securities in exchange for a contractual right to receive the securities back either upon request or after a certain time has elapsed. Section 1058 of the Internal Revenue Code (Code), however, provides that no gain or loss is recognized as long as the securities loan satisfies certain criteria. A taxpayer that wishes to postpone gain or loss recognition can, therefore, ensure that her securities lending transaction satisfies the requirements of section 1058, while a taxpayer seeking to recognize gain or loss currently can enter into a securities lending transaction that does not satisfy section 1058.



## **Reasons for Change**

The disparate treatment of derivatives under current tax rules, which have evolved sporadically over more than 50 years, has created a regime that is essentially elective. Tax rules based on the form of a derivative allow banks and exchanges to construct economically equivalent contracts to achieve different desired tax results. Sophisticated taxpayers can use these instruments to achieve the timing and character that meets their objectives. At the same time, the wide variance in the tax treatment of derivative contracts that are economically similar leads to uncertainty about how the tax rules apply.

## **Proposal**

The proposal would require that gain or loss from a derivative contract be reported on an annual basis as if the contract were sold for its fair market value no later than the last business day of the taxpayer's taxable year (marked to market). Gain or loss resulting from the contract would be treated as ordinary and as attributable to a trade or business of the taxpayer. The source of income associated with a derivative would continue to be determined under current law. A derivative contract would be broadly defined to include (1) any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property; and (2) any contract with respect to a contract that is described in (1). A derivative contract that is embedded in another financial instrument or contract would be subject to mark to market if the derivative by itself would be marked to market. Consequently, the mark to market treatment would apply to contingent debt and structured notes linked to actively traded property. In addition, a financial instrument (e.g., stock) that is not otherwise marked to market that is part of (or becomes part of) a straddle transaction with a derivative contract would be marked to market, with preexisting gain recognized at that time and loss recognized when the financial instrument would have been recognized in the absence of the straddle.

Mark to market accounting would not be required for a transaction that qualifies as a business hedging transaction. A business hedging transaction is a transaction that is entered into in the ordinary course of a taxpayer's trade or business primarily to manage risk of price changes (including changes related to interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary obligations, and that is identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. A transaction would satisfy the identification requirement if it is identified as a business hedge for financial accounting purposes and it hedges price changes on ordinary property or obligations.

The proposal would replace or amend a number of provisions that have been added to the Code to address transactions that have been deemed abusive over the years. Section 1256 (mark to market and 60/40 capital gain) and section 1092 (tax straddles) would be eliminated, while the application of section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sales transactions), and section 1260 (constructive ownership transactions) would be significantly curtailed.

The proposal would apply to derivative contracts entered into after December 31, 2013.

## **MODIFY RULES THAT APPLY TO SALES OF LIFE INSURANCE CONTRACTS**

### **Current Law**

The seller of a life insurance contract generally must report as taxable income the difference between the amount received from the buyer and the adjusted basis in the contract, unless the buyer is a viatical settlement provider and the insured person is terminally or chronically ill.

Under a transfer-for-value rule, the buyer of a previously issued life insurance contract who subsequently receives a death benefit generally is subject to tax on the difference between the death benefit received and the sum of the amount paid for the contract and premiums subsequently paid by the buyer. This rule does not apply if the buyer's basis is determined in whole or in part by reference to the seller's basis, nor does the rule apply if the buyer is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Persons engaged in a trade or business that make payments of premiums, compensation, remunerations, other fixed or determinable gains, profits, and income, or certain other types of payments in the course of that trade or business to another person generally are required to report such payments of \$600 or more to the Internal Revenue Service (IRS). However, reporting may not be required in some circumstances involving the purchase of a life insurance contract.

### **Reasons for Change**

Recent years have seen a significant increase in the number and size of life settlement transactions, wherein individuals sell previously-issued life insurance contracts to investors. Compliance is sometimes hampered by a lack of information reporting. In addition, the current law exceptions to the transfer-for-value rule may give investors the ability to structure a transaction to avoid paying tax on the profit when the insured person dies.

### **Proposal**

The proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

The proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The proposal would apply to sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2013.

## **MODIFY PRORATION RULES FOR LIFE INSURANCE COMPANY GENERAL AND SEPARATE ACCOUNTS**

### **Current Law**

Corporate taxpayers may generally qualify for a dividends-received deduction (DRD) with regard to dividends received from other domestic corporations, in order to prevent or limit taxable inclusion of the same income by more than one corporation. No DRD is allowed, however, in respect of any dividend on any share of stock (1) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property, or (2) that is held by the taxpayer for 45 days or less during the 91-day period beginning on the date that is 45 days before the share becomes ex-dividend with respect to the dividend. For this purpose, the taxpayer's holding period is reduced for any period in which the taxpayer has diminished its risk of loss by holding one or more positions with respect to substantially similar or related property.

In the case of a life insurance company, the DRD is permitted only with regard to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The regime for computing the company's share and policyholders' share of net investment income is sometimes referred to as proration.

The policyholders' share equals 100 percent less the company's share, whereas the latter is equal to the company's share of net investment income divided by net investment income. The company's share of net investment income is the excess, if any, of net investment income over certain amounts, including "required interest," that are set aside to satisfy obligations to policyholders. Required interest with regard to an account is calculated by multiplying a specified account earnings rate by the mean of the reserves with regard to the account for the taxable year.

A life insurance company's separate account assets, liabilities, and income are segregated from those of the company's general account in order to support variable life insurance and variable annuity contracts. A company's share and policyholders' share are computed for the company's general account and separately for each separate account.

### **Reasons for Change**

The proration methodology currently used by some taxpayers may produce a company's share that greatly exceeds the company's economic interest in the net investment income earned by its separate account assets, generating controversy between life insurance companies and the Internal Revenue Service. The purposes of the proration regime would be better served, and life insurance companies would be treated more like other taxpayers with a diminished risk of loss in stock or an obligation to make related payments with respect to dividends, if the company's share bore a more direct relationship to the company's actual economic interest in the account.

## **Proposal**

The proposal would repeal the existing regime for prorating investment income between the "company's share" and the "policyholders' share." The general account DRD, tax-exempt interest, and increases in certain policy cash values of a life insurance company would instead be subject to a fixed 15 percent proration in a manner similar to that which applies under current law to non-life insurance companies. The limitations on DRD that apply to other corporate taxpayers would be expanded to apply explicitly to life insurance company separate account dividends in the same proportion as the mean of reserves bears to the mean of total assets of the account. The proposal would thus put the company's general account DRD on a similar footing to that of a non-life company, and would put its separate account DRD on a similar footing to that of any other taxpayer with a diminished risk of loss in stock that it owns, or with an obligation to make related payments with regard to dividends.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **EXPAND PRO RATA INTEREST EXPENSE DISALLOWANCE FOR CORPORATE-OWNED LIFE INSURANCE**

### **Current Law**

In general, no Federal income tax is imposed on a policyholder with respect to the earnings credited under a life insurance or endowment contract, and Federal income tax generally is deferred with respect to earnings under an annuity contract (unless the annuity contract is owned by a person other than a natural person). In addition, amounts received under a life insurance contract by reason of the death of the insured generally are excluded from gross income of the recipient.

Interest on policy loans or other indebtedness with respect to life insurance, endowment, or annuity contracts generally is not deductible, unless the insurance contract insures the life of a key person of the business. A key person includes a 20-percent owner of the business, as well as a limited number of the business' officers or employees. However, this interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment, or annuity contract.

In addition, the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula. An exception to the pro rata interest disallowance applies with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. In the case of both life and non-life insurance companies, special proration rules similarly require adjustments to prevent or limit the funding of tax-deductible reserve increases with tax-preferred income, including earnings credited under life insurance, endowment, and annuity contracts that would be subject to the pro rata interest disallowance rule if owned by a non-insurance company.

### **Reasons for Change**

Leveraged businesses can fund deductible interest expenses with tax-exempt or tax-deferred income credited under life insurance, endowment, or annuity contracts insuring certain types of individuals. For example, these businesses frequently invest in investment-oriented insurance policies covering the lives of their employees, officers, directors, or owners. These entities generally do not take out policy loans or other indebtedness that is secured or otherwise traceable to the insurance contracts. Instead, they borrow from depositors or other lenders, or issue bonds. Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors, or 20-percent shareholders and fund deductible reserves with tax-exempt or tax-deferred income.

### **Proposal**

The proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers, or directors, other than 20-percent owners of a business that is the owner or beneficiary of the contracts.

The proposal would apply to contracts issued after December 31, 2013, in taxable years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would be treated as a new contract except that in the case of a master contract, the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

## **ELIMINATE FOSSIL FUEL PREFERENCES**

### **Eliminate Oil and Gas Preferences**

#### **REPEAL ENHANCED OIL RECOVERY (EOR) CREDIT**

##### **Current Law**

The general business credit includes a 15-percent credit for eligible costs attributable to EOR projects. If the credit is claimed with respect to eligible costs, the taxpayer's deduction (or basis increase) with respect to those costs is reduced by the amount of the credit. Eligible costs include the cost of constructing a gas treatment plant to prepare Alaska natural gas for pipeline transportation and any of the following costs with respect to a qualified EOR project: (1) the cost of depreciable or amortizable tangible property that is an integral part of the project; (2) intangible drilling and development costs (IDCs) that the taxpayer can elect to deduct; and (3) deductible tertiary injectant costs. A qualified EOR project must be located in the United States and must involve the application of one or more of nine listed tertiary recovery methods that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which ultimately will be recovered. The allowable credit is phased out over a \$6 range for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds an inflation adjusted threshold. The credit was completely phased out for taxable years beginning in 2011, because the reference price (\$74.71) exceeded the inflation adjusted threshold (\$42.91) by more than \$6.

##### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the credit must ultimately be financed with taxes that result in other distortions, e.g., in reductions in investment in other, potentially more productive, areas of the economy.

##### **Proposal**

The proposal would repeal the investment tax credit for enhanced oil recovery projects for taxable years beginning after December 31, 2013.

## **REPEAL CREDIT FOR OIL AND GAS PRODUCED FROM MARGINAL WELLS**

### **Current Law**

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit rate is \$3.00 per barrel of oil and 50 cents per 1,000 cubic feet of natural gas for taxable years beginning in 2005 and is adjusted for inflation in taxable years beginning after 2005. The credit is available for production from wells that produce oil and gas qualifying as marginal production for purposes of the percentage depletion rules or that have average daily production of not more than 25 barrel-of-oil equivalents and produce at least 95 percent water. The credit per well is limited to 1,095 barrels of oil or barrel-of-oil equivalents per year. The credit rate for crude oil is phased out for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are \$3.00 and \$15.00 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit rate for natural gas is similarly phased out for a taxable year if the annual average wellhead price for domestic natural gas exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are 33 cents and \$1.67 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit has been completely phased out for all taxable years since its enactment. Unlike other components of the general business credit, which can be carried back only one year, the marginal well credit can be carried back up to five years.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the credit must ultimately be financed with taxes that cause other economic distortions, e.g. underinvestment in other, potentially more productive, areas of the economy.

### **Proposal**

The proposal would repeal the production tax credit for oil and gas from marginal wells for production in taxable years beginning after December 31, 2013.



## **REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS**

### **Current Law**

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

Special rules apply to intangible drilling costs (IDCs). IDCs include all expenditures made by an operator (i.e., a person who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and amounts properly allocable to the cost of depreciable property) done by contractors under any form of contract (including a turnkey contract). IDCs include amounts paid for labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings) or items which are part of the acquisition price of an interest in the property.

Under the special rules applicable to IDCs, an operator who pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs. The uniform capitalization rules do not apply to otherwise deductible IDCs.

If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in the taxable year the cost is paid or incurred. Generally, IDCs that a taxpayer elects to capitalize may be recovered through depletion or depreciation, as appropriate; or in the case of a nonproductive well ("dry hole"), the operator may elect to deduct the costs. In the case of an integrated oil company (i.e., a company that engages, either directly or through a related enterprise, in substantial retailing or refining activities) that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.

A taxpayer that has elected to deduct IDCs may, nevertheless, elect to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this

provision. This allows the taxpayer to reduce or eliminate IDC adjustments or preferences under the alternative minimum tax.

The election to deduct IDCs applies only to those IDCs associated with domestic properties. For this purpose, the United States includes certain wells drilled offshore.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The expensing of IDCs, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the subsidy for oil and gas must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy. Capitalization of IDCs would place the oil and gas industry on a cost recovery system similar to that of other industries and reduce economic distortions.

### **Proposal**

The proposal would repeal expensing of IDCs and 60-month amortization of capitalized IDCs. IDCs would be capitalized as depreciable or depletable property, depending on the nature of the cost incurred, in accordance with the generally applicable rules.

The proposal would be effective for costs paid or incurred after December 31, 2013.

## **REPEAL DEDUCTION FOR TERTIARY INJECTANTS**

### **Current Law**

Taxpayers are allowed to deduct the cost of qualified tertiary injectant expenses for the taxable year. Qualified tertiary injectant expenses are amounts paid or incurred for any tertiary injectants (other than recoverable hydrocarbon injectants) that are used as a part of a tertiary recovery method to increase the recovery of crude oil. The deduction is treated as an amortization deduction in determining the amount subject to recapture upon disposition of the property.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The deduction for tertiary injectants, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy. Capitalization of tertiary injectants would place the oil and gas industry on a cost recovery system similar to that of other industries and reduce economic distortions.

### **Proposal**

The proposal would repeal the deduction for qualified tertiary injectant expenses for amounts paid or incurred after December 31, 2013.

## **REPEAL EXCEPTION TO PASSIVE LOSS LIMITATION FOR WORKING INTERESTS IN OIL AND NATURAL GAS PROPERTIES**

### **Current Law**

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Suspended deductions and credits are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses and credits from a passive activity are allowed in full when the taxpayer completely disposes of the activity.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. An exception is provided, however, for any working interest in an 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.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The special tax treatment of working interests in oil and gas properties, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the working interest exception for oil and gas must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy. Eliminating the working interest exception would subject oil and gas properties to the same limitations as other activities and reduce economic distortions.

### **Proposal**

The proposal would repeal the exception from the passive loss rules for working interests in oil and gas properties for taxable years beginning after December 31, 2013.

## **REPEAL PERCENTAGE DEPLETION FOR OIL AND NATURAL GAS WELLS**

### **Current Law**

The capital costs of oil and gas wells are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis.

A taxpayer may also qualify for percentage depletion with respect to oil and gas properties. The amount of the deduction is a statutory percentage of the gross income from the property. For oil and gas properties, the percentage ranges from 15 to 25 percent and the deduction may not exceed 100 percent of the taxable income from the property (determined before the deductions for depletion and domestic manufacturing). In addition, the percentage depletion deduction for oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before the deduction for depletion and with certain other adjustments).

Other limitations and special rules apply to the percentage depletion deduction for oil and gas properties. In general, only independent producers and royalty owners (in contrast to integrated oil companies) qualify for the percentage depletion deduction. In addition, oil and gas producers may claim percentage depletion only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (applied on a combined basis in the case of taxpayers that produce both). This quantity limitation is allocated, at the taxpayer's election, between oil production and gas production and then further allocated within each class among the taxpayer's properties. Special rules apply to oil and gas production from marginal wells (generally, wells for which the average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). Only marginal well production can qualify for percentage depletion at a rate of more than 15 percent. The rate is increased in a taxable year that begins in a calendar year following a calendar year during which the annual average unregulated wellhead price per barrel of domestic crude oil is less than \$20. The increase is one percentage point for each whole dollar of difference between the two amounts. In addition, marginal wells are exempt from the 100-percent-of-net-income limitation described above in taxable years beginning during the period 1998-2007 and in taxable years beginning during the period 2009-2011. Unless the taxpayer elects otherwise, marginal well production is given priority over other production in applying the 1,000-barrel limitation on percentage depletion.

A qualifying taxpayer determines the depletion deduction for each oil and gas property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

## **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. Percentage depletion effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy.

Cost depletion computed by reference to the taxpayer's basis in the property is the equivalent of economic depreciation. Limiting oil and gas producers to cost depletion would place them on a cost recovery system similar to that of other industries and reduce economic distortions.

## **Proposal**

The proposal would repeal percentage depletion with respect to oil and gas wells. Taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in oil and gas wells.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **REPEAL DOMESTIC MANUFACTURING DEDUCTION FOR OIL AND NATURAL GAS PRODUCTION**

### **Current Law**

A deduction is allowed with respect to income attributable to domestic production activities (the manufacturing deduction). For taxable years beginning after 2009, the manufacturing deduction is generally equal to 9 percent of the lesser of qualified production activities income for the taxable year or taxable income for the taxable year, limited to 50 percent of the W-2 wages of the taxpayer for the taxable year. The deduction for income from oil and gas production activities is computed at a 6 percent rate.

Qualified production activities income is generally calculated as a taxpayer's domestic production gross receipts (i.e., the gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States; any qualified film produced by the taxpayer; or electricity, natural gas, or potable water produced by the taxpayer in the United States) minus the cost of goods sold and other expenses, losses, or deductions attributable to such receipts.

The manufacturing deduction generally is available to all taxpayers that generate qualified production activities income, which under current law includes income from the sale, exchange or disposition of oil, natural gas or primary products thereof produced in the United States.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The manufacturing deduction for oil and gas effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy.

### **Proposal**

The proposal would retain the overall manufacturing deduction, but exclude from the definition of domestic production gross receipts all gross receipts derived from the sale, exchange or other disposition of oil, natural gas or a primary product thereof for taxable years beginning after December 31, 2013. There is a parallel proposal to repeal the domestic manufacturing deduction for coal and other hard mineral fossil fuels.

## **INCREASE GEOLOGICAL AND GEOPHYSICAL AMORTIZATION PERIOD FOR INDEPENDENT PRODUCERS TO SEVEN YEARS**

### **Current Law**

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The amortization period for geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States is two years for independent producers and seven years for integrated oil and gas producers.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The accelerated amortization of geological and geophysical expenditures incurred by independent producers, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy.

Increasing the amortization period for geological and geophysical expenditures incurred by independent oil and gas producers from two years to seven years would provide a more accurate reflection of their income and more consistent tax treatment for all oil and gas producers.

### **Proposal**

The proposal would increase the amortization period from two years to seven years for geological and geophysical expenditures incurred by independent producers in connection with all oil and gas exploration in the United States. Seven-year amortization would apply even if the property is abandoned and any remaining basis of the abandoned property would be recovered over the remainder of the seven-year period.

The proposal would be effective for amounts paid or incurred after December 31, 2013.



## **Eliminate Coal Preferences**

### **REPEAL EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS**

#### **Current Law**

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

Special rules apply in the case of mining exploration and development expenditures. A taxpayer may elect to expense the exploration costs incurred for the purpose of ascertaining the existence, location, extent, or quality of an ore or mineral deposit, including a deposit of coal or other hard-mineral fossil fuel. Exploration costs that are expensed are recaptured when the mine reaches the producing stage either by a reduction in depletion deductions or, at the election of the taxpayer, by an inclusion in income in the year in which the mine reaches the producing stage.

After the existence of a commercially marketable deposit has been disclosed, costs incurred for the development of a mine to exploit the deposit are deductible in the year paid or incurred unless the taxpayer elects to deduct the costs on a ratable basis as the minerals or ores produced from the deposit are sold.

In the case of a corporation that elects to deduct exploration costs in the year paid or incurred, 30 percent of the otherwise deductible costs must be capitalized and amortized over a 60-month period. In addition, a taxpayer that has elected to deduct exploration costs may, nevertheless, elect to capitalize and amortize those costs over a 10-year period. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its exploration costs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate adjustments or preferences for exploration costs under the alternative minimum tax. Similar rules limiting corporate deductions and providing for 60-month and 10-year amortization apply with respect to mine development costs.

The election to deduct exploration costs and the rule making development costs deductible in the year paid or incurred apply only with respect to domestic ore and mineral deposits.

#### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The expensing of exploration and development costs relating to coal and other hard-mineral fossil fuels, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy

and cutting carbon pollution. Moreover, the tax subsidy for coal and other hard-mineral fossil fuels must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy. Capitalization of exploration and development costs relating to coal and other hard-mineral fossil fuels would place taxpayers in that industry on a cost recovery system similar to that employed by other industries and reduce economic distortions.

### **Proposal**

The proposal would repeal expensing, 60-month amortization, and 10-year amortization of exploration and development costs with respect to coal and other hard-mineral fossil fuels. The costs would be capitalized as depreciable or depletable property, depending on the nature of the cost incurred, in accordance with the generally applicable rules. The other hard-mineral fossil fuels for which expensing, 60-month amortization, and 10-year amortization would not be allowed include lignite and oil shale to which a 15-percent depletion rate applies.

The proposal would be effective for costs paid or incurred after December 31, 2013.

## **REPEAL PERCENTAGE DEPLETION FOR HARD MINERAL FOSSIL FUELS**

### **Current Law**

The capital costs of coal mines and other hard-mineral fossil-fuel properties are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis.

A taxpayer may also qualify for percentage depletion with respect to coal and other hard-mineral fossil-fuel properties. The amount of the deduction is a statutory percentage of the gross income from the property. The percentage is 10 percent for coal and lignite and 15 percent for oil shale (other than oil shale to which a 7 ½ percent depletion rate applies because it is used for certain nonfuel purposes). The deduction may not exceed 50 percent of the taxable income from the property (determined before the deductions for depletion and domestic manufacturing).

A qualifying taxpayer determines the depletion deduction for each property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. Percentage depletion effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy and cutting carbon pollution. Moreover, the tax subsidy for coal and other hard-mineral fossil fuels must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy.

Cost depletion computed by reference to the taxpayer's basis in the property is the equivalent of economic depreciation. Limiting fossil-fuel producers to cost depletion would place them on a cost recovery system similar to that of other industries and reduce economic distortions.

### **Proposal**

The proposal would repeal percentage depletion with respect to coal and other hard-mineral fossil fuels. The other hard-mineral fossil fuels for which no percentage depletion would be allowed include lignite and oil shale to which a 15-percent depletion rate applies. Taxpayers

would be permitted to claim cost depletion on their adjusted basis, if any, in coal and other hard-mineral fossil-fuel properties.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **REPEAL CAPITAL GAINS TREATMENT FOR ROYALTIES**

### **Current Law**

Royalties received on the disposition of coal or lignite generally qualify for treatment as long-term capital gain, and the royalty owner does not qualify for percentage depletion with respect to the coal or lignite. This treatment does not apply unless the taxpayer has been the owner of the mineral in place for at least one year before it is mined. The treatment also does not apply to income realized as a co-adventurer, partner, or principal in the mining of the mineral or to certain related-party transactions.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The capital gain treatment of coal and lignite royalties, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy and cutting carbon pollution. Moreover, the tax subsidy for coal and lignite must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy.

### **Proposal**

The proposal would repeal capital gains treatment of coal and lignite royalties and would tax those royalties as ordinary income.

The proposal would be effective for amounts realized in taxable years beginning after December 31, 2013.

## **REPEAL DOMESTIC MANUFACTURING DEDUCTION FOR THE PRODUCTION OF COAL AND OTHER HARD MINERAL FOSSIL FUELS**

### **Current Law**

A deduction is allowed with respect to income attributable to domestic production activities (the manufacturing deduction). For taxable years beginning after 2009, the manufacturing deduction is generally equal to 9 percent of the lesser of qualified production activities income for the taxable year or taxable income for the taxable year, limited to 50 percent of the W-2 wages of the taxpayer for the taxable year.

Qualified production activities income is generally calculated as a taxpayer's domestic production gross receipts (i.e., the gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States; any qualified film produced by the taxpayer; or electricity, natural gas, or potable water produced by the taxpayer in the United States) minus the cost of goods sold and other expenses, losses, or deductions attributable to such receipts.

The manufacturing deduction generally is available to all taxpayers that generate qualified production activities income, which under current law includes income from the sale, exchange or disposition of coal, other hard-mineral fossil fuels, or primary products thereof produced in the United States.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The manufacturing deduction for coal and other hard mineral fossil fuels effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy and cutting carbon pollution. Moreover, the tax subsidy for coal and other hard-mineral fossil fuels must ultimately be financed with taxes that cause other economic distortions, e.g., underinvestment in other, potentially more productive, areas of the economy.

### **Proposal**

The proposal would retain the overall manufacturing deduction, but exclude from the definition of domestic production gross receipts all gross receipts derived from the sale, exchange or other disposition of coal, other hard-mineral fossil fuels, or a primary product thereof. The hard mineral fossil fuels to which the exclusion would apply include lignite and oil shale to which a 15-percent depletion rate applies. There is a parallel proposal to repeal the domestic manufacturing deduction for oil and natural gas companies.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS**

### **REPEAL THE EXCISE TAX CREDIT FOR DISTILLED SPIRITS WITH FLAVOR AND WINE ADDITIVES**

#### **Current Law**

Distilled spirits are currently taxed at a rate of \$13.50 per proof-gallon. (A proof-gallon is one liquid gallon of spirits that is 50 percent alcohol (100 proof) at 60 degrees F). Some distilled spirits are flavored with additives. Section 5010 of the Internal Revenue Code allows a credit against the \$13.50 per proof gallon excise tax on distilled spirits for flavor and wine additives, reducing the effective excise rate paid on distilled spirits with such content. The credit is available on distilled spirits that are produced in the U.S. as well as on distilled spirits that are imported into the U.S.

The value of the section 5010 credit comes from two sources: (1) up to 2.5 percent of the distilled spirits in a mixture that comes from flavors is tax-exempt, though flavors above this level are taxed at the distilled spirit rate, and (2) the wine component of the additive is taxed at the wine rate, which is less than the tax rate on distilled spirits.

#### **Reasons for Change**

The tax credit introduces differences in the prices of similar goods, and thereby distorts decisions by producers and consumers. Consumers may favor distilled spirit products with additives because of their comparatively lower price, relative to similar products with the same overall alcohol content but without additives. In addition, the credit encourages producers to use additives. In the first year following the enactment of the credit (1981), roughly 1 million proof-gallons of wines and flavors were mixed with 300 million proof-gallons of spirits. Since then the volume of wines and flavors have increased substantially while the volume of spirits used in mixed products has stayed roughly constant. In 2011, 11 million proof-gallons of wines and flavors were mixed with 314 million gallons of spirits.

The credit creates tax advantages for foreign producers and production compared to domestic production. Some countries allow greater use of additives than the U.S. allows. This can lead to larger credits for foreign producers. In addition, the Alcohol and Tobacco Tax and Trade Bureau (TTB) of the U.S. Treasury does not have the authority for on-site audits of foreign producers. In contrast, TTB can perform on-site audits of domestic producers to verify the additives used.

Calculating the credit and enforcing compliance with the provision is complicated for producers and TTB, as it requires information about the specific components of the beverage rather than alcohol content alone. Repeal would raise revenue and simplify tax collections.

#### **Proposal**

The proposal would repeal the section 5010 credit for distilled spirits and tax all distilled spirit beverages at the \$13.50 per proof-gallon rate.



The proposal would be effective for all spirits produced in or imported into the United States after December 31, 2013.

## **REPEAL LAST-IN, FIRST-OUT (LIFO) METHOD OF ACCOUNTING FOR INVENTORIES**

### **Current Law**

A taxpayer with inventory may determine the value of its inventory and its cost of goods sold using a number of different methods. The most prevalent method is the first-in, first-out (FIFO) method, which matches current sales with the costs of the earliest acquired (or manufactured) inventory items. As an alternative, a taxpayer may elect to use the LIFO method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. The LIFO method can provide a tax benefit for a taxpayer facing rising inventory costs, since the cost of goods sold under this method is based on more recent, higher inventory values, resulting in lower taxable income. If inventory levels fall during the year, however, a LIFO taxpayer must include lower-cost LIFO inventory values (reflecting one or more prior-year inventory accumulations) in the cost of goods sold, and its taxable income will be correspondingly higher. To be eligible to elect LIFO for tax purposes, a taxpayer must use LIFO for financial accounting purposes.

### **Reasons for Change**

Repeal of the LIFO method would eliminate a tax deferral opportunity available to taxpayers that hold inventories, the costs of which increase over time. In addition, LIFO repeal would simplify the Internal Revenue Code by removing a complex and burdensome accounting method that has been the source of controversy between taxpayers and the Internal Revenue Service.

International Financial Reporting Standards do not permit the use of the LIFO method, and their adoption by the Securities and Exchange Commission would cause violations of the current LIFO book/tax conformity requirement. Repealing LIFO would remove this possible impediment to the implementation of these standards in the United States.

### **Proposal**

The proposal would repeal the use of the LIFO inventory accounting method for Federal income tax purposes. Taxpayers that currently use the LIFO method would be required to change their method of inventory accounting, resulting in the inclusion in income of prior-years' LIFO inventory reserves (the amount of income deferred under the LIFO method). The resulting section 481(a) adjustment, which is a one-time increase in gross income, would be taken into account ratably over ten years, beginning with the year of change.

The repeal is proposed to be effective for the first taxable year beginning after December 31, 2013.

## **REPEAL LOWER-OF-COST-OR-MARKET (LCM) INVENTORY ACCOUNTING METHOD**

### **Current Law**

Taxpayers required to maintain inventories are permitted to use a variety of methods to determine the cost of their ending inventories, including methods such as the last-in, first-out (LIFO) method, the first-in, first-out method, and the retail method. Taxpayers not using a LIFO method may: (1) write down the carrying values of their inventories by applying the LCM method instead of the cost method; and (2) write down the cost of “subnormal” goods (i.e., those that are unsalable at normal prices or unusable in the normal way because of damage, imperfection, or other similar causes).

### **Reasons for Change**

The allowance of inventory write-downs under the LCM and subnormal goods provisions is an exception from the realization principle, and is essentially a one-way mark-to-market regime that understates taxable income. Thus, a taxpayer is able to obtain a larger cost-of-goods-sold deduction by writing down an item of inventory if its replacement cost falls below historical cost, but need not increase an item’s inventory value if its replacement cost increases above historical cost. This asymmetric treatment is unwarranted. Also, the market value used under LCM for tax purposes generally is the replacement or reproduction cost of an item of inventory, not the item’s net realizable value, as is required under generally accepted financial accounting rules. While the operation of the retail method is technically symmetric, it also allows retailers to obtain deductions for write-downs below inventory cost because of normal and anticipated declines in retail prices.

### **Proposal**

The proposal would statutorily prohibit the use of the LCM and subnormal goods methods. Appropriate wash-sale rules also would be included to prevent taxpayers from circumventing the prohibition. The proposal would result in a change in the method of accounting for inventories for taxpayers currently using the LCM and subnormal goods methods, and any resulting section 481(a) adjustment generally would be included in income ratably over a four-year period beginning with the year of change.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **MODIFY DEPRECIATION RULES FOR GENERAL AVIATION PASSENGER AIRCRAFT**

### **Current Law**

Under the depreciation rules, the recovery period for airplanes not used in commercial or contract carrying of passengers or freight (including corporate jets) generally is five years and the recovery period for airplanes and other assets (including ground property, but excluding helicopters) used in commercial or contract carrying of passengers or freight generally is seven years.

### **Reasons for Change**

The shorter recovery period for depreciating airplanes not used in commercial or contract carrying of passengers or freight provides a tax preference for corporate jets and similar airplanes used primarily for transportation of passengers. To eliminate the preference for these airplanes over similar commercial transportation airplanes, their recovery periods should be harmonized.

### **Proposal**

The proposal would define “general aviation passenger aircraft” to mean any airplane (including airframes and engines) not used in commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than an airplane used primarily in emergency or emergency relief operations).

The proposal would increase the recovery period for depreciating general aviation passenger aircraft from five years to seven years. Correspondingly, for taxpayers using the alternative depreciation system, the recovery period for general aviation passenger aircraft would be extended to 12 years.

Any airplane not used in commercial or contract carrying of passengers or freight, but which is primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.) and any helicopter would continue to be depreciated using a recovery period of five years (six years under the alternative depreciation system).

The proposal would be effective for property placed in service after December 31, 2013.

## **REPEAL GAIN LIMITATION FOR DIVIDENDS RECEIVED IN REORGANIZATION EXCHANGES**

### **Current Law**

Under section 356(a)(1), if as part of a reorganization transaction an exchanging shareholder receives in exchange for stock of the target corporation both stock and property that cannot be received without the recognition of gain (often referred to as “boot”), the exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the “boot-within-gain” limitation). Further, under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder’s ratable share of the corporation’s earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

### **Reasons for Change**

There is not a significant policy reason to vary the treatment of a distribution that otherwise qualifies as a dividend by reference to whether it is received in the normal course of a corporation’s operations or is instead received as part of a reorganization exchange. Thus, repealing the boot-within-gain limitation for an exchange that has the effect of the distribution of a dividend will provide more uniform treatment for dividends that is less dependent on context. Moreover, in cross-border reorganizations, the boot-within-gain limitation can permit U.S. shareholders to repatriate previously-untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences. For example, if the exchanging shareholder’s stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the corporation has previously untaxed earnings and profits equal to or greater than the boot. This result is inconsistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation.

### **Proposal**

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).

The proposal would be effective for taxable years beginning after December 31, 2013.

## **EXPAND THE DEFINITION OF BUILT-IN LOSS FOR PURPOSES OF PARTNERSHIP LOSS TRANSFERS**

### **Current Law**

Under section 743(b), a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made an election under section 754 to make basis adjustments or the partnership has a substantial built-in loss. If an election is in effect or the partnership has a substantial built-in loss, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

Prior to 2004, section 743(b) applied only if the partnership made an election under section 754. To prevent the duplication of losses, Congress amended section 743 to mandate section 743(b) adjustments if the partnership had a substantial built-in loss in its assets. Section 743(d) defines a substantial built-in loss by reference to the partnership's adjusted basis – that is, there is a substantial built-in loss if the partnership's adjusted basis in its assets exceeds by more than \$250,000 the fair market value of such property.

### **Reasons for Change**

Although the 2004 amendments to section 743 prevent the duplication of losses where the partnership has a substantial built-in loss in its assets, it does not prevent the duplication of losses where the transferee partner would be allocated a net loss in excess of \$250,000 if the partnership sold all of its assets in a fully taxable transaction for fair market value, but the partnership itself does not have a substantial built-in loss in its assets.

### **Proposal**

The proposal would amend section 743(d) to also measure a substantial built-in loss by reference to whether the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a full taxable transaction for cash equal to the fair market value of the assets.

The proposal would apply to sales or exchanges after the date of enactment.

## **EXTEND PARTNERSHIP BASIS LIMITATION RULES TO NONDEDUCTIBLE EXPENDITURES**

### **Current Law**

Section 704(d) provides that a partner's distributive share of loss is allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership year in which such loss occurred. Any excess is allowed as a deduction at the end of the partnership year in which the partner has sufficient basis in its partnership interest to take the deductions. Section 704(d) does not apply to partnership expenditures not deductible in computing partnership taxable income and not properly chargeable to capital account.

### **Reasons for Change**

Even though a partner's distributive share of nondeductible expenditures reduces the partner's basis in its partnership interest, such items are not subject to section 704(d), and the partner may deduct or credit them currently even if the partner's basis in its partnership interest is zero.

### **Proposal**

The proposal would amend section 704(d) to allow a partner's distributive share of expenditures not deductible in computing the partnership's taxable income and not properly chargeable to capital account only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership year in which such expenditure occurred.

The proposal would apply to a partnership's taxable year beginning on or after the date of enactment.

## **LIMIT THE IMPORTATION OF LOSSES UNDER RELATED PARTY LOSS LIMITATION RULES**

### **Current Law**

If a loss sustained by a transferor is disallowed under section 267(a)(1) or section 707(b)(1) because the transferor and transferee are related under section 267(b) or section 707(b)(1), section 267(d) provides that the transferee may reduce any gain the transferee later recognizes on a disposition of the transferred asset by the amount of the loss disallowed to the transferor. This has the effect of shifting the benefit of the loss from the transferor to the transferee.

### **Reasons for Change**

Because section 267(d) shifts the benefit of the loss from the transferor to the transferee, losses can be imported where gain or loss with respect to the property is not subject to Federal income tax in the hands of the transferor immediately before the transfer but any gain or loss with respect to the property is subject to Federal income tax in the hands of the transferee immediately after the transfer.

### **Proposal**

The proposal would amend section 267(d) to provide that the principles of section 267(d) do not apply to the extent gain or loss with respect to the property is not subject to Federal income tax in the hands of the transferor immediately before the transfer but any gain or loss with respect to the property is subject to Federal income tax in the hands of the transferee immediately after the transfer.

The proposal would apply to transfers made after the date of enactment.



## **DENY DEDUCTION FOR PUNITIVE DAMAGES**

### **Current Law**

No deduction is allowed for a fine or similar penalty paid to a government for the violation of any law. If a taxpayer is convicted of a violation of the antitrust laws, or the taxpayer's plea of guilty or nolo contendere to such a violation is entered or accepted in a criminal proceeding, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or in settlement of a civil suit brought under section 4 of the Clayton Antitrust Act on account of such violation or any related antitrust violation. Where neither of these two provisions is applicable, a deduction is allowed for damages paid or incurred as ordinary and necessary expenses in carrying on any trade or business, regardless of whether such damages are compensatory or punitive.

### **Reasons for Change**

The deductibility of punitive damage payments undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities.

### **Proposal**

The proposal would disallow a deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report such payments to the insured person and to the Internal Revenue Service.

The proposal would apply to damages paid or incurred after December 31, 2014.

## **ELIMINATE SECTION 404(k) EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) DIVIDEND DEDUCTION FOR LARGE C CORPORATIONS**

### **Current Law**

Generally, corporations do not receive a corporate income tax deduction for dividends paid to their shareholders. However, C corporations are allowed a deduction for dividends paid with respect to employer stock held in an ESOP if certain conditions are met. To be eligible for this treatment, the dividend must be an “applicable dividend.” For this purpose, a dividend qualifies as an applicable dividend only if the provisions of the ESOP provide that the dividend is paid or used in accordance with one of four available alternatives. Specifically, a dividend qualifies as an applicable dividend if the provisions of the ESOP provide that the dividend is paid directly to the plan’s participants or their beneficiaries, paid to the plan and distributed to participants or their beneficiaries not later than 90 days after the end of the plan year, or, at the election of the participants or their beneficiaries, is either paid directly to the participants or their beneficiaries or paid to the plan and distributed to the participants or their beneficiaries not later than 90 days after the end of the plan year. Alternatively, a dividend qualifies as an applicable dividend if the plan terms provide that it may be used to repay a loan originally used to purchase the stock with respect to which the dividend is paid. For this purpose, the dividend qualifies as an applicable dividend only to the extent that employer securities with a fair market value of not less than the amount of the dividend are allocated to the accounts to which the dividend would have been allocated. The limitation of deductibility of dividends used to repay loans to those paid with respect to stock acquired with those loans does not apply to employer securities acquired by an ESOP prior to August 4, 1989 (if the plan was an ESOP prior to that date).

A deduction for a dividend that otherwise qualifies as an applicable dividend may be disallowed if the Secretary determines that the dividend is, in substance, an “avoidance or evasion” of taxation. This includes authority to disallow a deduction of unreasonable dividends, which has been used to recharacterize excess dividends as contributions subject to the limit on annual additions under section 415. Thus, the authority to disallow a deduction for a dividend serves not only to disallow the deduction but also to constrain any dividend that, in substance, constitutes an employer contribution to the ESOP in excess of the otherwise applicable limit on annual additions.

When distributed to participants or their beneficiaries, either directly or from the plan, applicable dividends constitute taxable plan distributions (ordinary income) but are not subject to the 10% early distribution tax. Applicable dividends are not treated as wages for purposes of income tax withholding or federal employment taxes.

### **Reasons for Change**

Current law extends several tax benefits to ESOPs that are in addition to those applicable to other tax-qualified retirement plans. The ESOP dividend deduction is one of these benefits. Thus, while current law does not allow a paying corporation a deduction for dividends paid with respect to its stock, including stock that is held in a retirement plan, the deduction for dividends on employer stock held in an ESOP constitutes an exception to this rule. The difference in

treatment creates an additional incentive for employers to encourage investment in employer stock through ESOPs. Concentration of employees' retirement savings in the stock of the company for which they work, however, subjects employees' retirement benefits to increased risk (potentially the same risk that could affect their job security) without necessarily offering a commensurate return. To the extent that current payments of dividends to ESOP participants may be viewed as having a productivity incentive effect, the effect may be more likely in small firms, where each employee's efforts could more directly affect overall company performance and where there may be a greater possibility that the benefits of any such incentives could justify the risks associated with concentration of retirement savings in employer stock. By providing an exception from elimination of the ESOP dividend deduction for smaller corporations, the proposal seeks to strike a balance between these competing considerations.

### **Proposal**

The proposal would repeal the deduction for dividends paid with respect to stock held by an ESOP that is sponsored by a C corporation (subject to an exception for C corporations with annual receipts of \$5 million or less). The current law rules allowing for immediate payment or use of an applicable dividend would remain intact, without a deduction, and be moved to section 4975(f)(7), which currently provides corresponding rules for distributions (as described in section 1368(a)) with respect to S corporation stock held in an ESOP maintained by a S corporation that is used to repay the loan or loans with which the stock with respect to which the distribution is paid was originally purchased. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

The proposal would apply to dividends and distributions that are paid after the date of enactment.



## **BUDGET PROPOSALS**

---

The Administration's proposals, which begin the process of reducing the deficit and reforming the Internal Revenue Code, will strengthen the economy and provide support to middle-income families. These proposals provide support for job creation and incentives for investment in infrastructure, and help families save for retirement and pay for college and child care. They also reduce the deficit and make the tax system fairer by eliminating a number of tax loopholes and reducing tax benefits for higher-income taxpayers. The Administration's proposals that affect receipts are described below.

## **TAX RELIEF TO CREATE JOBS AND JUMPSTART GROWTH**

### **PROVIDE SMALL BUSINESSES A TEMPORARY 10-PERCENT TAX CREDIT FOR NEW JOBS AND WAGE INCREASES**

#### **Current Law**

Under current law, there is no generally available income tax credit for job creation or increasing employees' wages.

#### **Reasons for Change**

Although the economy is recovering from a severe economic recession and the private sector has increased employment, a tax credit designed to stimulate job creation and wage increases could help put more Americans back to work, provide tax relief targeted at America's small businesses, and strengthen the foundation of the economic recovery.

#### **Proposal**

Under the proposal, qualified employers would be provided a tax credit for increases in wage expense, whether driven by new hires, increased wages, or both. The credit would be equal to 10 percent of the increase in the employer's eligible wages paid during the credit period over the employer's eligible wages paid during the base period. Base period wages are calculated using wages paid in 2012. The credit period is the twelve month period following the date of enactment. Eligible wages are the employer's Old Age Survivors and Disability Insurance (OASDI) wages. The maximum amount of the increase in eligible wages would be \$5 million per employer, for a maximum credit of \$500,000. For employers with no OASDI wages in the base period, eligible wages would be 80 percent of their OASDI wages paid in the credit period. To focus the benefit on small businesses, the credit would be limited to employers with less than \$20 million in OASDI wages in 2012. The credit would be a general business credit. A similar credit would be provided for qualified tax-exempt employers. The Secretary may prescribe rules with respect to eligible wages.

The credit would only apply with respect to the wages of employees performing services in a trade or business of a qualified employer or, in the case of a qualified employer exempt from tax under section 501(a), in furtherance of the activities related to the purpose or function constituting the basis of the employer's exemption under section 501. Self-employment income would not be considered eligible wages.

A qualified employer means any employer other than the United States, any State or possession of the United States, or any political subdivision thereof, or any instrumentality of the foregoing. A qualified employer also includes any employer that is a public institution of higher education (as defined in section 101 of the Higher Education Act of 1965).

For purposes of determining the \$5 million limit on the maximum amount of OASDI wages available for the credit, all employees of all corporations that are members of the same controlled

group (using the 80-percent ownership test for filing a consolidated return) would be treated as employed by a single employer. For partnerships, proprietorships, etc., all employees under common control would be treated as employed by a single employer. The Secretary may prescribe rules with respect to predecessor and successor employers.

The credit also would be available for increases in earnings subject to tier 1 Railroad Retirement taxes subject to OASDI rates (section 3111(a)).

Similar benefits would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

The proposal would be effective for qualified wages paid during the twelve-month period beginning on the date of enactment.

## **PROVIDE ADDITIONAL TAX CREDITS FOR INVESTMENT IN QUALIFIED PROPERTY USED IN A QUALIFYING ADVANCED ENERGY MANUFACTURING PROJECT**

### **Current Law**

A 30-percent tax credit is provided for investments in eligible property used in a qualifying advanced energy project. A qualifying advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for the production of: (1) property designed to produce energy from renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric vehicles; (3) electric grids to support the transmission, including storage, of intermittent sources of renewable energy; (4) property designed to capture and sequester carbon dioxide emissions; (5) property designed to refine or blend renewable fuels or to produce energy conservation technologies; (6) electric drive motor vehicles that qualify for tax credits or components designed for use with such vehicles; and (7) other advanced energy property designed to reduce greenhouse gas emissions.

Eligible property is property: (1) that is necessary for the production of the property listed above; (2) that is tangible personal property or other tangible property (not including a building and its structural components) that is used as an integral part of a qualifying facility; and (3) with respect to which depreciation (or amortization in lieu of depreciation) is allowable.

Under the American Recovery and Reinvestment Act of 2009 (ARRA), total credits were limited to \$2.3 billion, and the Treasury Department, in consultation with the Department of Energy, was required to establish a program to consider and award certifications for qualified investments eligible for credits within 180 days of the date of enactment of ARRA. Credits may be allocated only to projects where there is a reasonable expectation of commercial viability. In addition, consideration must be given to which projects: (1) will provide the greatest domestic job creation; (2) will have the greatest net impact in avoiding or reducing air pollutants or greenhouse gas emissions; (3) have the greatest potential for technological innovation and commercial deployment; (4) have the lowest levelized cost of generated or stored energy, or of measured reduction in energy consumption or greenhouse gas emission; and (5) have the shortest completion time. Guidance under current law requires taxpayers to apply for the credit with respect to their entire qualified investment in a project.

Applications for certification under the program may be made only during the two-year period beginning on the date the program is established. An applicant that is allocated credits must provide evidence that the requirements of the certification have been met within one year of the date of acceptance of the application and must place the property in service within three years from the date of the issuance of the certification.

### **Reasons for Change**

The \$2.3 billion cap on the credit has resulted in the funding of less than one-third of the technically acceptable applications that have been received. Rather than turning down worthy projects that could be deployed quickly to create jobs and support economic activity, the



program – which has proven successful in leveraging private investment in building and equipping factories that manufacture clean energy products in America – should be expanded.

### **Proposal**

The proposal would authorize an additional \$2.5 billion of credits for investments in eligible property used in a qualifying advanced energy manufacturing project. Taxpayers would be able to apply for a credit with respect to part or all of their qualified investment. If a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government would be taken into account in determining whether to allocate credits to the project.

Applications for the additional credits would be made during the two-year period beginning on the date on which the additional authorization is enacted. As under current law, applicants that are allocated the additional credits must provide evidence that the requirements of the certification have been met within one year of the date of acceptance of the application and must place the property in service within three years from the date of the issuance of the certification.

The change would be effective as of the date of enactment.

## **DESIGNATE PROMISE ZONES**

### **Current Law**

The Internal Revenue Code contains various incentives targeted to encourage the development of particular geographic regions, including empowerment zones. In addition, qualifying investment placed in service in 2013 is eligible for additional first-year depreciation of the adjusted basis of the property.

### **Empowerment Zones**

There are 40 empowerment zones—30 in urban areas and 10 in rural areas—that were designated through a competitive application process in three separate rounds in 1994, 1998, and 2002. State and local governments nominated distressed geographic areas, which were selected on the strength of their strategic plans for economic and social revitalization. The urban areas were designated by the Secretary of Housing and Urban Development. The rural areas were designated by the Secretary of Agriculture. Empowerment zone designation remains in effect through December 31, 2013.

Incentives for businesses in empowerment zones include (1) a 20-percent wage credit for qualifying wages, (2) additional expensing for qualified zone property, (3) tax-exempt financing for certain qualifying zone facilities, (4) deferral of capital gains on sales and reinvestment in empowerment zone assets, and (5) exclusion of 60 percent (rather than 50 percent) of the gain on the sale of qualified small business stock held more than 5 years. For qualified small business stock acquired after September 27, 2010 and before January 1, 2014, the exclusion percentage increases to 100 percent. This provision (100-percent exclusion) applies to all qualified small business stock, not just that issued by enterprise zone businesses.

The wage credit provides a 20-percent subsidy on the first \$15,000 of annual wages paid to residents of empowerment zones by businesses located in these communities, if substantially all of the employee's services are performed within the zone. The credit is not available for wages taken into account in determining the work opportunity tax credit (WOTC).

To be eligible for the capital incentives, businesses must generally satisfy the requirements of an enterprise zone business. Among other conditions, these requirements stipulate that at least 50 percent of the total gross income of such business is derived from the active conduct of a business within an empowerment zone, a substantial portion of the use of tangible property of such business is within an empowerment zone, and at least 35 percent of its employees are residents of an empowerment zone.

Enterprise zone businesses are allowed to expense the cost of certain qualified zone property (which, among other requirements, must be used in the active conduct of a qualified business in an empowerment zone) up to an additional \$35,000 above the amounts generally available under section 179. In addition, only 50 percent of the cost of such qualified zone property counts toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

Qualified enterprise zone businesses are eligible to apply for tax-exempt financing (empowerment zone facility bonds) for qualified zone property. These empowerment zone facility bonds do not count against state private activity bond limits; instead a limit is placed upon each zone, depending on population and whether the zone is in an urban or rural area.

In addition, residents of empowerment zones aged 18-39 years old qualify as a targeted group for the WOTC. Employers who hire an individual in a targeted group receive a 40-percent credit that applies to the first \$6,000 of qualified first-year wages. Empowerment zone residents aged 16-17 can also qualify as a targeted group for WOTC, but the qualifying wage limit is reduced to \$3,000 and the period of employment must be between May 1 and September 15.

### **Bonus Depreciation**

An additional first-year depreciation deduction is allowed for qualified property placed in service during 2013. The deduction equals 50 percent of the cost of qualified property, and is allowed for both regular tax and alternative minimum tax purposes. The property's depreciable basis is adjusted to reflect this additional deduction. However, the taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Qualified property for this purpose includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. Qualified property must be new property, and excludes property that is required to be depreciated under the alternative depreciation system (ADS). To qualify for the 50-percent additional first-year depreciation deduction, property must be (1) acquired after December 31, 2007, and before January 1, 2014 (but only if no written binding contract for the acquisition was in effect before January 1, 2008), or (2) acquired pursuant to a written binding contract entered into after December 31, 2007, and before January 1, 2014. In general, the property must be placed in service by January 1, 2014. If property is self-constructed, the taxpayer must begin manufacture or construction of the property after December 31, 2007, and before January 1, 2014. An extension by one year of the placed-in-service date is allowed for certain property with a recovery period of ten years or longer and certain transportation property, if the property has an estimated production period exceeding one year and a cost exceeding \$1 million. Certain aircraft not used in providing transportation services are also granted a one-year extension of the placed-in-service deadline. In these cases, the additional allowance applies only to adjusted basis attributable to manufacture or construction occurring before January 1, 2014. Special rules apply to syndications, sale-leasebacks, and transfers to related parties of qualified property.

### **Reasons for Change**

Promise zones would promote job creation and investment in economically distressed areas that have demonstrated potential for future growth and diversification into new industries. While current law provides regionally targeted benefits to numerous areas, these incentives are due to expire soon and some of these designations have been in effect for almost 20 years. The Administration desires to target resources to areas where they would provide the most benefit on a going-forward basis. In particular, the national competition for promise zone status would encourage such areas to develop rigorous plans for economic growth that connect the zone to

drivers of regional economic growth. The targeted tax incentives provided to the zone would encourage private sector investment and other forms of increased economic activity in these areas. The current tax incentives are perceived as complex and difficult for businesses to navigate, potentially reducing the take-up rate for these incentives.

### **Proposal**

The Administration proposes to designate 20 promise zones (14 in urban areas and 6 in rural areas). The zones would be designated in four rounds of five zones each, which would become effective at the beginning of 2015, 2016, 2017, and 2018. Zone designations and corresponding tax incentives would last for 10 years. The Secretary of Commerce would select the zones in consultation with the Secretary of Housing and Urban Development, the Secretary of Agriculture, the Secretary of Education, the Attorney General, the Secretary of Health and Human Services, the Secretary of Labor, and the Secretary of the Treasury.

The zones would be chosen through a competitive application process. To apply, an applicant would need the formal support of a State, county, city, or other general purpose political subdivision of a State or possession (a “local government”), or an Indian tribal government. Applicant areas could be supported by more than one local government, if the applicant area is within the jurisdiction of more than one local government or State. In addition, local governments within a region could join together to jointly support multiple applicant areas for promise zone status, so long as each designated zone independently satisfies the eligibility criteria. To be eligible to apply, an area must satisfy the following criteria:

1. An applicant area would have to have a continuous boundary (that is, an area must be a single area; it cannot be comprised of two or more separate areas) and could not exceed 20 square miles if an urban area or 1,000 square miles if a rural area.
2. An applicant urban area would have to include a portion of at least one local government jurisdiction with a population of at least 50,000. The population of an applicant urban area could not exceed the lesser of: (1) 200,000; or (2) the greater of 50,000 or 10 percent of the population of the most populous city in the nominated area. A nominated rural area could not have a population that exceeded 30,000.

Applicant areas would be designated as promise zones based on the strength of the applicant’s “competitiveness plan” and its need to attract investment and jobs. Communities would be encouraged to develop a strategic plan to build on their economic strengths and outline targeted investments to develop their competitive advantages. Collaboration across a wide range of stakeholders would be useful in developing a coherent and comprehensive strategic plan. A successful plan would clearly outline how the economic strategy would connect the zone to drivers of regional economic growth.

In evaluating applications, the Secretary of Commerce could consider other factors, including: unemployment rates, poverty rates, household income, home-ownership, labor force participation and educational attainment. In addition, the Secretary may set minimal standards

for the levels of unemployment and poverty that must be satisfied by the nominated applicant area.

“Rural area” would be defined as any area that is (1) outside of a metropolitan statistical area (within the meaning of section 143(k)(2)(B)), or (2) determined by the Secretary of Commerce, after consultation with the Secretary of Agriculture, to be a rural area. “Urban area” would be defined as any area that is not a rural area.

Two tax incentives would be applicable to promise zones. First, an employment credit would be provided to businesses that employ zone residents. The credit would apply to the first \$15,000 of qualifying zone employee wages. The credit rate would be 20 percent for zone residents who are employed within the zone and 10 percent for zone residents employed outside of the zone. The definition of a qualified zone employee would follow rules found in section 1396(d). For the purposes of the 10-percent credit, the requirement that substantially all of the services performed by the employee for the employer are within the zone would not apply. The definition of qualified zone wages would follow the definitions provided in section 1396(c) and 1397(a).

Second, qualified property placed in service within the zone would be eligible for additional first-year depreciation of 100 percent of the adjusted basis of the property. Qualified property for this purpose includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. Qualified property must be new property. Qualified property excludes property that is required to be depreciated under the ADS. The taxpayer must purchase (or begin the manufacture or construction of) the property after the date of zone designation and before the zone designation ends (but only if no written binding contract for the acquisition was in effect before zone designation). The property must be placed in service within the zone while the zone designation is in effect.

The Secretary of the Treasury would be given authority to collect data from taxpayers on the use of such tax incentives by zone. The Secretary of Commerce may require the nominating local government to provide other data on the economic conditions in the zones both before and after designation. These data would be used to evaluate the effectiveness of the promise zones program.

## **INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE**

### **PROVIDE AMERICA FAST FORWARD BONDS AND EXPAND ELIGIBLE USES**

#### **Current Law**

Build America Bonds are a lower-cost borrowing tool for State and local governments that were enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA). Traditional tax-exempt bonds provide for lower borrowing costs for State and local governments indirectly through a Federal tax exemption to investors for the interest income received on the bonds. By comparison, Build America Bonds are taxable bonds issued by State and local governments in which the Federal Government makes direct payments to State and local governmental issuers (called “refundable tax credits”) to subsidize a portion of their borrowing costs in an amount equal to 35 percent of the coupon interest on the bonds. Issuance of Build America Bonds is limited to original financing for public capital projects for which issuers otherwise could use tax-exempt “governmental bonds” (as contrasted with “private activity bonds,” which benefit private entities). ARRA authorized the issuance of Build America Bonds in 2009 and 2010 without volume limitation, and the authority to issue these bonds expired at the end of 2010. Issuers could choose in 2009 and 2010 to issue Build America Bonds or traditional tax-exempt bonds.

Tax-exempt bonds have broader program parameters than Build America Bonds. In addition to using the bonds for original financing for public capital projects like Build America Bonds, tax-exempt bonds may generally be used for: (1) “current refundings” to refinance prior governmental bonds for interest cost savings where the prior bonds are repaid promptly within 90 days of issuance of the refunding bonds; (2) short-term “working capital” financings for governmental operating expenses for seasonal cash flow deficits; (3) financing for section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities; and (4) qualified private activity bond financing for specified private projects and programs (including, for example, mass commuting facilities, solid waste disposal facilities, low-income residential rental housing projects, and single-family housing for low and moderate income homebuyers, among others), which are subject to annual State bond volume caps with certain exceptions.

#### **Reasons for Change**

The Build America Bond program has been successful and has expanded the market for State and local governmental debt. From April 2009 through December 2010, approximately \$185 billion in Build America Bonds were issued in 2,899 transactions in all 50 States, the District of Columbia, and two territories. During 2009 and 2010, Build America Bonds gained one-third of the market of the total dollar supply of State and local new, long-term governmental debt.

This program taps into a broader market for investors without regard to tax liability (e.g., pension funds may be investors in Build America Bonds, though they typically do not invest in tax-exempt bonds). By comparison, traditional tax-exempt bonds have a narrower class of investors, which generally consist of retail investors (individuals and mutual funds hold over 70 percent of tax-exempt bonds).

The Build America Bond program delivers an efficient Federal subsidy directly to State and local governments (rather than through third-party investors). By comparison, tax-exempt bonds can be viewed as inefficient in that the Federal revenue cost of the tax exemption is often greater than the benefits to State and local governments achieved through lower borrowing costs. The Build America Bond program also has a potentially more streamlined tax compliance framework focusing directly on governmental issuers who benefit from the subsidy, as compared with tax-exempt bonds and tax credit bonds, which involve investors as tax intermediaries. The Build America Bond program also has relieved supply pressures in the tax-exempt bond market and has helped to reduce interest rates in that market.

America Fast Forward Bonds would build upon the successful example of the Build America Bond program by providing a new bond program with broader uses that will attract new sources of capital for infrastructure investment (e.g., pension funds may be investors in America Fast Forward Bonds, though they typically do not invest in tax-exempt bonds).

### **Proposal**

America Fast Forward Bonds. The proposal would create a new, permanent America Fast Forward Bond program that would be an optional alternative to traditional tax-exempt bonds. Like Build America Bonds, America Fast Forward Bonds would be taxable bonds issued by State and local governments in which the Federal Government makes direct payments to State and local governmental issuers (through refundable tax credits). For the permanent America Fast Forward Bond program, the Treasury Department would make direct payments to State and local governmental issuers in an amount equal to 28 percent of the coupon interest on the bonds. The 28 percent Federal subsidy level is intended to be approximately revenue neutral relative to the estimated future Federal tax expenditures for tax-exempt bonds. The America Fast Forward program should facilitate greater efficiency, a broader investor base, and lower costs for State and local governmental debt.

Eligible Uses. Eligible uses for America Fast Forward Bonds would include: (1) original financing for governmental capital projects, as under the authorization of Build America Bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid promptly within 90 days of issuance of the current refunding bonds; (3) short-term governmental working capital financings for governmental operating expenses (such as tax and revenue anticipation borrowings for seasonal cash flow deficits), subject to a 13-month maturity limitation; and (4) financing for section 501(c)(3) nonprofit entities.

Include as an Eligible Use Qualified Private Activity Bond Program Uses. In addition to including financing for section 501(c)(3) nonprofit entities, eligible uses also include financing for the types of projects and programs that can be financed with qualified private activity bonds, subject to the applicable State bond volume caps for the qualified private activity bond category. The proposal would be effective for bonds issued on or after January 1, 2014.

## **INCREASE THE FEDERAL SUBSIDY RATE FOR AMERICA FAST FORWARD BONDS FOR SCHOOL CONSTRUCTION**

### **Current Law**

State and local governments issue tax-exempt bonds to finance a wide range of projects, including school construction. There are two basic kinds of tax-exempt bonds: governmental bonds and qualified private activity bonds. Bonds generally are treated as governmental bonds if the proceeds are used to carry out governmental purposes or the bonds are repaid with governmental funds. Bonds that have excess private business involvement or private loans are classified as “private activity bonds.” Private activity bonds may be issued on a tax-exempt basis only if they meet the general requirements for governmental bonds and certain additional requirements necessary for “qualified private activity bonds.” Qualified private activity bonds can be issued to finance construction at certain schools and universities. For example, qualified section 501(c)(3) bonds, a type of qualified private activity bond, can be issued to finance nonprofit schools and nonprofit universities. Qualified section 501(c)(3) bonds are not subject to an annual unified State volume cap.

In addition to tax-exempt bonds, Build America Bonds are another way to finance educational facilities. Build America Bonds were enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA). Build America Bonds are taxable bonds issued by State and local governments in which the Federal Government makes direct payments to State and local governmental issuers (called “refundable credits”) to subsidize a portion of their borrowing costs in an amount equal to 35 percent of the coupon interest on the bonds. Issuance of Build America Bonds was limited to original financing for public capital projects for which issuers otherwise could use tax-exempt governmental bonds. ARRA authorized the issuance of Build America Bonds in 2009 and 2010 without volume limitation, and the authority to issue these bonds expired at the end of 2010. Issuers could choose in 2009 and 2010 to issue Build America Bonds or traditional tax-exempt bonds. In 2009 and 2010, approximately \$50 billion of Build America Bonds were issued to finance education.

### **Reasons for Change**

The Build America Bond program has been successful and has expanded the market for State and local governmental debt. Among the benefits of the Build America Bond program are: (1) a broader market for investors without regard to tax liability (e.g., pension funds may be investors in Build America Bonds, though they typically do not invest in tax-exempt bonds); and (2) a program that delivers an efficient Federal subsidy directly to State and local governments (rather than through third-party investors).

Aging educational facilities create a need to renovate older educational facilities and to encourage construction of new facilities. America Fast Forward Bonds for School Construction build upon the successful example of the Build America Bond program by providing a new bond program that will attract new sources of capital for investment in our nation’s school and universities.



## **Proposal**

The proposal provides a temporary 50-percent Federal subsidy rate for America Fast Forward Bonds for School Construction. Eligible uses would be: (1) original financings for governmental capital projects for public schools and state universities; and (2) new money financings for section 501(c)(3) nonprofit educational entities, such as nonprofit schools and nonprofit universities that could use qualified section 501(c)(3) bonds. Issuers could choose to issue America Fast Forward Bonds for School Construction or traditional tax-exempt bonds. For America Fast Forward Bonds for School Construction issued in 2014 and 2015, the Treasury Department would make direct payments (through refundable tax credits) to State and local governmental issuers in an amount equal to 50 percent of the coupon interest on the bonds. This represents a deeper Federal subsidy for temporary stimulus purposes than the existing permanent Federal subsidy inherent in tax-exempt governmental bonds or qualified section 501(c)(3) bonds or the proposed 28-percent Federal subsidy rate for the permanent America Fast Forward Bond program.

To target new investment in education, the 50-percent Federal subsidy rate would not apply to current refundings of prior governmental capital financings for public schools and state universities or current refundings of prior financings for section 501(c)(3) educational entities.

The proposal would be effective for bonds issued in 2014 and 2015.

## **ALLOW CURRENT REFUNDINGS OF STATE AND LOCAL GOVERNMENTAL BONDS**

### **Current Law**

The Internal Revenue Code (Code) provides Federal tax subsidies for lower borrowing costs on debt obligations issued by States and local governments and political subdivisions thereof (“State and local bonds”). The Code delivers Federal borrowing subsidies to State and local governments in different ways. Section 103 provides generally for the issuance of tax-exempt bonds for eligible governmental purposes at lower borrowing costs based on the excludability of the interest paid on the bonds from the gross income of the owners of the bonds. Other State or local bond provisions provide Federal borrowing subsidies to State and local governments through direct subsidy payments (called “refundable tax credits”) to State and local governmental issuers, tax credits to investors in certain tax credit bonds to replace specified portions of the interest on those bonds, and other collateral tax advantages to State and local bonds.

From time to time, for reasons associated with Federal cost considerations and other targeting objectives, various State and local bond provisions have had bond volume caps, time deadlines for bond issuance, or transitional provisions for program restrictions. For example, Section 54AA enacted by the American Recovery and Reinvestment Act of 2009 (ARRA) authorized the issuance of taxable Build America Bonds in 2009 and 2010 for governmental capital projects and provided for direct borrowing subsidy payments to issuers for 35 percent of the borrowing costs. In addition, Section 54A authorizes the issuance of certain Qualified Tax Credit Bonds for targeted public school and energy programs under specified bond volume caps and within certain time periods. Other examples of targeted, temporary bond provisions include a \$25 billion authorization for “Recovery Zone Bonds” in Section 1400U1-3; a temporary exception to the alternative minimum tax preference for interest on tax-exempt private activity bonds under Section 57(a)(5); and a temporary increase in the size of a small issuer exception (from \$10 million to \$30 million) to the tax-exempt carrying cost disallowance rule for financial institutions in Section 265(b).

In the tax-exempt bond area, a “current refunding” or “current refunding issue” (under Treas. Reg. §1.150-1(d)(3)) refers to bonds used to refinance prior bonds in circumstances in which the prior bonds are redeemed or retired within 90 days after issuance of the current refunding bonds.

### **Reasons for Change**

Tax policy favors current refundings of State and local bonds within appropriate size and maturity parameters because these current refundings generally reduce both: (1) borrowing costs for State and local governmental issuers; and (2) Federal revenue costs or tax expenditure costs

of Federal subsidies for borrowing costs on State and local bonds. The primary reason that States and local governments engage in current refunding transactions is to reduce interest costs.<sup>3</sup> The extent to which statutory provisions address current refundings has varied among different State and local bond program provisions. Selected examples of provisions that address current refundings include the following: Section 1313(a) of the Tax Reform Act of 1986 (general transition rule); Section 147(b) (private activity bond volume cap); Section 142(i)(9) (bond volume cap for qualified green buildings and sustainable design projects); Section 142(m)(4) (bond volume cap for qualified highway or surface freight transfer projects); and Section 1394(f)(3)(C)(ii) (bond volume cap for new empowerment zone facility bonds). By contrast, other State and local bond programs do not address current refundings expressly. Selected examples of provisions that do not address current refundings expressly include Build America Bonds under Section 54AA, Qualified Tax Credit Bonds under Section 54A, and Recovery Zone Bonds under Section 1400U1-3.

In light of the disparate statutory treatment of current refundings and the lack of express consideration of current refundings in certain statutory provisions, a general statutory provision that sets forth parameters for allowable current refundings of State and local bonds would promote greater uniformity and tax certainty.

### **Proposal**

The proposal would provide a general Code provision to authorize current refundings of State or local bonds upon satisfaction of the following requirements:

1. **Size Limit.** The issue price of the current refunding bonds would be required to be no greater than the outstanding principal amount (generally meaning the outstanding stated principal amount, except as provided below) of the refunded bonds. For bonds issued with more than a de minimis amount of original issue discount or premium, the adjusted issue price or accreted present value of the refunded bonds would be required to be used as the measure of this size limitation in lieu of the outstanding stated principal amount of the refunded bonds.
2. **Maturity Limit.** The weighted average maturity of the current refunding bonds would be required to be no longer than the remaining weighted average maturity of the refunded bonds (determined in the manner provided in Section 147(b)).

This provision would apply generally to State and local bond programs or provisions that do not otherwise allow current refundings or expressly address the treatment of current refundings (including bonds for which bond volume caps or time deadlines applied to issuance of original bonds). This provision would be inapplicable to State and local bond programs or provisions that otherwise allow or expressly address current refundings, such as traditional tax-exempt governmental bonds under Section 103 for which current refundings generally are allowable without statutory bond maturity restrictions and qualified tax-exempt private activity bonds

---

<sup>3</sup> By comparison, an “advance refunding” refers to a refinancing in which the refunding bonds and the prior bonds may remain outstanding concurrently for more than 90 days. Advance refundings involve duplicative Federal subsidy costs for the same financed project or purpose. Section 149(d) restricts advance refundings.

under Section 141(e) for which current refundings generally are allowable within prescribed statutory bond maturity restrictions under Section 147(b).

The proposal would be effective as of the date of enactment.

## **REPEAL THE \$150 MILLION NON-HOSPITAL BOND LIMITATION ON QUALIFIED SECTION 501(c)(3) BONDS**

### **Current Law**

Section 501(c)(3) bonds can be used to finance either capital expenditures or working capital expenditures of section 501(c)(3) organizations. The Tax Reform Act of 1986 established a \$150 million limit on the volume of outstanding, non-hospital, tax-exempt section 501(c)(3) bonds. The limit was repealed in 1997 with respect to bonds issued after August 5, 1997, if at least 95 percent of the net proceeds were used to finance capital expenditures incurred after that date. Thus, the limitation continues to apply to bonds more than five percent of the net proceeds of which finance or refinance (1) working capital expenditures, or (2) capital expenditures, incurred on or before August 5, 1997.

### **Reasons for Change**

The \$150 million limitation results in complexity and provides disparate treatment depending on the nature and timing of bond-financed expenditures. Issuers must determine whether an issue consists of non-hospital bonds, and they must calculate the amount of non-hospital bonds that are allocable to a particular tax-exempt organization. In addition, issuers must determine whether more than five percent of the net proceeds of each issue of non-hospital bonds finances working capital expenditures, or capital expenditures incurred on or before August 5, 1997, to determine whether the issue is subject to the limitation. Repealing the limitation would enable nonprofit universities to utilize tax-exempt financing on a basis comparable to public universities.

### **Proposal**

The \$150 million limit on the volume of outstanding, non-hospital, tax-exempt bonds for the benefit of any one section 501(c)(3) organization would be repealed in its entirety, effective for bonds issued after the date of enactment.

## **INCREASE NATIONAL LIMITATION AMOUNT FOR QUALIFIED HIGHWAY OR SURFACE FREIGHT TRANSFER FACILITY BONDS**

### **Current Law**

Tax-exempt private activity bonds may be used to finance qualified highway or surface freight transfer facilities. A qualified highway or surface freight transfer facility is (1) any surface transportation project, (2) any project for an international bridge or tunnel for which an international entity authorized under Federal or State law is responsible, or (3) any facility for the transfer of freight from truck to rail or rail to truck. These projects must receive Federal assistance under title 23 of the United States Code or, in the case of facilities for the transfer of freight from truck to rail or rail to truck, Federal assistance under either title 23 or title 49 of the United States Code.

Tax-exempt bonds issued to finance qualified highway or surface freight transfer facilities are not subject to State volume limitations. Instead, the Secretary of Transportation is authorized to allocate a total of \$15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.

The proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Bond proceeds that remain unspent after five years must be used to redeem outstanding bonds.

### **Reasons for Change**

Qualified highway or surface freight transfer facility bonds are a permitted category of tax-exempt private activity bond that permit private involvement in qualified highway or surface transfer projects. Increasing by \$4 billion the issuance amount of these types of bonds is consistent with the Administration's policy of supporting investment in highway and freight transfer projects, especially in light of the expansion of the Transportation Infrastructure Finance and Innovation Act as part of the recent Moving Ahead for Progress in the 21<sup>st</sup> Century Act's surface transportation reauthorization.

### **Proposal**

The proposal would increase the \$15 billion aggregate amount permitted to be allocated by the Secretary of Transportation to \$19 billion.

The proposal would be effective upon enactment.

## **ELIMINATE THE VOLUME CAP FOR PRIVATE ACTIVITY BONDS FOR WATER INFRASTRUCTURE**

### **Current law**

State and local governments issue tax-exempt bonds to finance a wide range of public infrastructure projects. In general, the interest on bonds issued by State and local governments is excludable from gross income if the bonds meet certain eligibility requirements. There are two basic kinds of tax-exempt bonds: governmental bonds and qualified private activity bonds. Bonds generally are treated as governmental bonds if the proceeds are used to carry out governmental purposes or the bonds are repaid with governmental funds. In general, there are limits on the private business use of proceeds, including loans, as well as private business repayment of governmental bonds. Governmental bonds are subject to various general restrictions, including arbitrage investment restrictions, registration and reporting requirements, Federal guarantee restrictions, advance refunding limitations, spending period limitations, and pooled bond limitations. Governmental bonds, however, are not subject to specific volume limitations.

Private activity bonds may be issued on a tax-exempt basis only if they meet the general requirements for governmental bonds and the additional requirements necessary for “qualified” private activity bonds. Qualified private activity bonds include exempt facility bonds, qualified mortgage bonds for single-family housing, qualified veterans’ mortgage bonds, qualified small issue bonds, qualified student loan bonds, qualified redevelopment bonds, and qualified section 501(c)(3) bonds. Eligible facilities for which exempt facility bonds may be issued include facilities for the furnishing of water and sewage facilities. Most qualified private activity bonds are subject to an annual unified State volume cap.

### **Reasons for Change**

The nation’s water and wastewater infrastructure facilities are essential to the important national public policy interests in ensuring clean and safe drinking water and sanitation. There is a significant need for capital funding to upgrade the nation’s water and wastewater infrastructure facilities. The Environmental Protection Agency’s surveys of 20-year capital investment needs estimate \$335 billion (2007 dollars) will be needed for drinking water supplies and \$298 billion (2008 dollars) for wastewater and storm water treatment. Removing the volume cap on tax-exempt qualified private activity bonds for water and wastewater infrastructure facilities would encourage additional needed private investment and public-private partnerships in these infrastructure facilities.

### **Proposal**

The proposal would provide an exception to the unified annual State volume cap on tax-exempt qualified private activity bonds for exempt facilities for the “furnishing of water” or “sewage facilities.” These bonds are intended to complement Environmental Protection Agency and local efforts to finance water quality improvement projects in the United States.

The proposal would be effective for bonds issued after the date of enactment to finance water or sewage facilities.



## **INCREASE THE 25-PERCENT LIMIT ON LAND ACQUISITION RESTRICTION ON QUALIFIED PRIVATE ACTIVITY BONDS**

### **Current Law**

In general, the interest on bonds issued by State and local governments is excludable from gross income if the bonds meet certain eligibility requirements. Section 147 provides that except for certain limited exceptions, a private activity bond is not a qualified bond if it is part of an issue where 25 percent or more of the net proceeds are to be used for the acquisition of land. For land used for farming purposes, no portion of bond proceeds may be used to acquire such land unless the purchase is by a “first-time farmer” who will be the principal user of the land and will materially and substantially participate on the farm.

Section 147 provides an exception to the rule limiting the amount of bond proceeds that can be used for land acquisition where bond proceeds are used by a governmental unit to acquire land in connection with an airport, mass commuting facility, high-speed intercity rail facility, dock, or wharf, if such land is acquired for the purpose of noise abatement, wetland preservation, or for future uses as an airport, mass commuting facility, high-speed intercity rail facility, dock, or wharf, and there is no other significant use of such land. The restriction also does not apply to qualified mortgage bonds, qualified veterans’ mortgage bonds, qualified student loan bonds, qualified section 501(c)(3), bonds, or qualified public educational facility bonds.

### **Reasons for Change**

The purpose of the land acquisition restriction was to ensure that bond proceeds were not used primarily to finance land purchases. However, since this restriction was enacted in 1984, land costs have steadily increased, thus prohibiting bond financing of many projects that once fell within the intent of the 25 percent exception. Increasing the percentage of the amount of bond proceeds that can be used for land acquisition would account for the steady increase in land costs and make it easier to bond finance projects in areas where land values have substantially increased.

### **Proposal**

The proposal would increase the 25 percent land acquisition restriction to 35 percent on certain qualified private activity bonds.

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

## **ALLOW MORE FLEXIBLE RESEARCH ARRANGEMENTS FOR PURPOSES OF THE PRIVATE BUSINESS USE LIMITS**

### **Current Law**

Section 141 treats tax-exempt bonds issued by State and local governments as governmental bonds if the issuer limits private business use and other private involvement sufficiently to avoid treatment as “private activity bonds.” Bonds generally are classified as private activity bonds if more than 10 percent of the bond proceeds are both (1) used for private business, and (2) payable or secured from property or payments derived from private business use. Except for certain qualified private activity bonds, the interest on private activity bonds is taxable.

For purposes of the private business limits on tax-exempt bonds, private business use of a bond-financed project generally means any direct or indirect use in a trade or business by any person other than a qualified user. Qualified users include State and local governmental units for tax-exempt governmental bonds and section 501(c)(3) exempt entities for qualified 501(c)(3) bonds. Under these rules, the Federal government also is treated like a private business. The following types of actual or beneficial use of a tax-exempt bond-financed project by a private business generally constitute private business use: ownership of a project; leasing of a project; certain contractual legal rights to use a project; certain incentive-payment contracts with respect to a project; and certain economic benefits derived from a project. One type of contractual arrangement that raises private business use questions is public-private research arrangements involving the conduct of research at tax-exempt bond-financed research facilities.

The legislative history of the Tax Reform Act of 1986 states that, to avoid impermissible private business use, the research arrangement must include specific features. For example, in the case of corporate-sponsored research, subject to certain restrictions, a tax-exempt bond-financed university facility may be used for corporate-sponsored research under a research agreement without being considered private business use. In particular, the sponsor must pay a competitive price for its use of the technology developed under the research agreement. Moreover, the price must be determined at the time the technology is available for use rather than an earlier time (such as when the research agreement is entered into).

Reflecting this legislative history, Treasury regulations provide safe harbors that allow certain research arrangements with private businesses at tax-exempt bond financed research facilities without giving rise to private business use. The safe harbors reflect the constraints enumerated in the legislative history.

### **Reasons for Change**

Research and technological innovation provide benefits to educational institutions and to society at large. Research involves significant investment and considerable uncertainty regarding the total costs, necessary lead time, and ultimate outcome of advancing scientific knowledge. More flexible standards for public-private research arrangements for purposes of the private business limits on tax-exempt bonds than those allowed under existing safe harbors potentially would

foster greater investment in research, greater technological innovation, and broader benefits to society at large.

### **Proposal**

The proposal would provide an exception to the private business limits on tax-exempt bonds for research arrangements relating to basic research at tax-exempt bond-financed research facilities that meet the following requirements:

(1) A qualified user (a State and local government or section 501(c)(3) nonprofit entity) would be required to own the research facilities.

(2) A qualified user would be permitted to enter into any bona fide, arm's-length contractual arrangement with a private business sponsor of basic research regarding the terms for sharing the economic benefits of any products resulting from the research, including arrangements in which those economic terms (such as exclusive or non-exclusive licenses of intellectual property, and licensing fees or royalty rates) are determined in advance at the time the parties enter into the contractual arrangement.

The proposal would be effective for research agreements entered into after the date of enactment.

## **REPEAL THE GOVERNMENT OWNERSHIP REQUIREMENT FOR CERTAIN TYPES OF EXEMPT FACILITY BONDS**

### **Current Law**

State and local governments are eligible to issue governmental bonds for a wide range of public infrastructure projects and other projects if the bond proceeds are used predominately for State and local government use or the bonds are payable or secured predominately from State and local government sources of payments, such as generally applicable taxes. State and local governments are also eligible to issue tax-exempt private activity bonds under section 141(e) with permitted private business use and other private involvement to finance certain specified types of projects. One type of permitted tax-exempt private activity bond is an exempt facility bond under section 142. The Internal Revenue Code permits tax-exempt financing with respect to different categories of “exempt facilities” under section 142 including airports, docks and wharves, and mass commuting facilities.

Under section 142, airports, docks and wharves, and mass commuting facilities are treated as exempt facilities only if all of the property to be financed with the net proceeds of the tax-exempt bond issue is to be owned by a governmental unit.

To qualify as exempt facilities that are eligible for tax-exempt bond financing, airports, docks and wharves, and mass commuting facilities must also meet a public use requirement. The public use requirement requires that the facility financed must serve or be available on a regular basis for general public use.

### **Reasons for Change**

The Administration has consistently emphasized the importance of infrastructure investment and the role that private capital can play in enhancing such investment. Eliminating the requirement that airports, docks and wharves, and mass commuting facilities must be governmentally owned will facilitate and encourage needed private sector investment in this infrastructure.

### **Proposal**

The proposal would repeal the requirement under section 142 that airports, docks and wharves, and mass commuting facilities must be owned by a governmental unit.

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

## **EXEMPT FOREIGN PENSION FUNDS FROM THE APPLICATION OF THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)**

### **Current Law**

FIRPTA, enacted in 1980, is intended to subject foreign investors to the same U.S. tax treatment on gains from the disposition of U.S. real property interests as that which applies to U.S. investors. Thus, under FIRPTA, when a nonresident alien individual or foreign corporation sells an interest in U.S. real estate (including directly held real property and stock in corporations that predominantly hold real property), any gain on the sale generally is subject to U.S. tax.

U.S. pension or retirement trusts or similar arrangements whose purpose is to provide pension or retirements benefits generally are exempt from U.S. tax (U.S. pension funds). For example, trusts forming part of qualified pension, profit sharing, or stock bonus plans generally are exempt from U.S. tax under section 501(a).

### **Reasons for Change**

Gain of a U.S. pension fund from the disposition of a U.S. real property interest generally is exempt from U.S. tax, but gain of a similar pension fund created or organized outside the United States from the disposition of that same property would be subject to U.S. tax under FIRPTA.

### **Proposal**

The proposal would exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests. For this purpose, a foreign pension fund would generally mean a trust, corporation, or other organization or arrangement that is created or organized outside of the United States; generally exempt from income tax in the jurisdiction in which it is created or organized; and substantially all of the activity of which is to administer or provide pension or retirement benefits. The Secretary would be granted authority to issue regulations necessary to carry out the purposes of the proposal, including whether for this purpose an entity or arrangement is a foreign pension fund or a benefit is a pension or retirement benefit.

The proposal would be effective for dispositions of U.S. real property interests occurring after December 31, 2013.

## **TAX CUTS FOR FAMILIES AND INDIVIDUALS**

### **PROVIDE FOR AUTOMATIC ENROLLMENT IN INDIVIDUAL RETIREMENT ACCOUNTS OR ANNUITIES (IRAS), INCLUDING A SMALL EMPLOYER TAX CREDIT, AND DOUBLE THE TAX CREDIT FOR SMALL EMPLOYER PLAN START-UP COSTS**

#### **Current Law**

A number of tax-preferred, employer-sponsored retirement savings programs exist under current law. These include section 401(k) cash or deferred arrangements, section 403(b) programs for public schools and charitable organizations, section 457 plans for governments and nonprofit organizations, and simplified employee pensions (SEPs) and SIMPLE plans for small employers.

Small employers (those with no more than 100 employees) that adopt a new qualified retirement, SEP or SIMPLE plan are entitled to a temporary business tax credit equal to 50 percent of the employer's plan "start-up costs," which are the expenses of establishing or administering the plan, including expenses of retirement-related employee education with respect to the plan. The credit is limited to a maximum of \$500 per year for three years.

Individuals who do not have access to an employer-sponsored retirement savings arrangement may be eligible to make smaller tax-favored contributions to IRAs.

In 2013, IRA contributions are limited to \$5,500 a year (plus \$1,000 for those age 50 or older). Section 401(k) plans permit contributions (employee plus employer contributions) of up to \$17,500 a year (of which \$5,500 can be pre-tax employee contributions) plus \$5,500 of additional pre-tax employee contributions for those age 50 or older.

#### **Reasons for Change**

For many years, until the economic downturn in 2008, the personal saving rate in the United States has been exceedingly low. Tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In addition, the proportion of U.S. workers participating in employer-sponsored plans has remained stagnant for decades at no more than about half the total work force, notwithstanding repeated private- and public-sector efforts to expand coverage. Among employees eligible to participate in an employer-sponsored retirement savings plan such as a 401(k) plan, participation rates typically have ranged from two-thirds to three-quarters of eligible employees, but making saving easier by making it automatic has been shown to be remarkably effective at boosting participation well above these levels.

Beginning in 1998, Treasury and the Internal Revenue Service (IRS) issued a series of rulings and other guidance defining, permitting, and encouraging automatic enrollment in 401(k) and other plans (i.e., enrolling employees by default unless they opt out). Automatic enrollment was further facilitated by the Pension Protection Act of 2006. In 401(k) plans, automatic enrollment has tended to increase participation rates to more than nine out of ten eligible employees. In contrast, for workers who lack access to a retirement plan at their workplace and are eligible to

engage in tax-favored retirement saving by taking the initiative and making the decisions required to establish and contribute to an IRA, the IRA participation rate tends to be less than one out of ten.

Numerous employers, especially those with smaller or lower-wage work forces, have been reluctant to adopt a retirement plan for their employees, in part out of concern about their ability to afford the cost of making employer contributions or the per-capita cost of complying with tax-qualification and ERISA (Employee Retirement Income Security Act) requirements. These employers could help their employees save -- without employer contributions or plan qualification or ERISA compliance -- simply by making their payroll systems available as a conduit for regularly transmitting employee contributions to an employee's IRA. Such "payroll deduction IRAs" could build on the success of workplace-based payroll-deduction saving by using the capacity to promote saving that is inherent in employer payroll systems, and the effort to help employees save would be especially effective if automatic enrollment were used. However, despite efforts more than a decade ago by the Department of the Treasury, the IRS, and the Department of Labor to approve and promote the option of payroll deduction IRAs, few employers have adopted them or even are aware that this option exists.

Accordingly, requiring employers that do not sponsor any retirement plan (and meet other criteria such as being above a certain size) to make their payroll systems available to employees and automatically enroll them in IRAs could achieve a major breakthrough in retirement savings coverage. In addition, requiring automatic IRAs may lead many employers to take the next step and adopt an employer plan, thereby permitting much greater tax-favored employee contributions than an IRA, plus the option of employer contributions. The potential for the use of automatic IRAs to lead to the adoption of 401(k)s, SIMPLEs, and other employer plans would be enhanced by raising the existing small employer tax credit for the start-up costs of adopting a new retirement plan to an amount significantly higher than both its current level and the level of the proposed new automatic IRA tax credit for employers.

In addition, the process of saving and choosing investments in automatic IRAs could be simplified for employees, and costs minimized, through a standard default investment as well as electronic information and fund transfers. Workplace retirement savings arrangements made accessible to most workers also could be used as a platform to provide and promote retirement distributions over the worker's lifetime.

### **Proposal**

The proposal would require employers in business for at least two years that have more than ten employees to offer an automatic IRA option to employees, under which regular contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsored a qualified retirement plan, SEP, or SIMPLE for its employees, it would not be required to provide an automatic IRA option for its employees. Thus, for example, a qualified plan sponsor would not have to offer automatic IRAs to employees it excludes from qualified plan eligibility because they are covered by a collective bargaining agreement, are under age eighteen, are nonresident aliens, or have not completed the plan's eligibility waiting period. However, if the qualified plan excluded from eligibility a portion of the employer's work force or a class of employees such as

all employees of a subsidiary or division, the employer would be required to offer the automatic IRA option to those excluded employees.

The employer offering automatic IRAs would give employees a standard notice and election form informing them of the automatic IRA option and allowing them to elect to participate or opt out. Any employee who did not provide a written participation election would be enrolled at a default rate of three percent of the employee's compensation in an IRA. Employees could opt out or opt for a lower or higher contribution rate up to the IRA dollar limits. Employees could choose either a traditional IRA or a Roth IRA, with Roth being the default. For most employees, the payroll deductions would be made by direct deposit similar to the direct deposit of employees' paychecks to their accounts at financial institutions.

Payroll-deduction contributions from all participating employees could be transferred, at the employer's option, to a single private-sector IRA trustee or custodian designated by the employer. Alternatively, the employer, if it preferred, could allow each participating employee to designate the IRA provider for that employee's contributions or could designate that all contributions would be forwarded to a savings vehicle specified by statute or regulation.

Employers making payroll deduction IRAs available would not have to choose or arrange default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation. In addition, this approach would involve no employer contributions, no employer compliance with qualified plan requirements, and no employer liability or responsibility for determining employee eligibility to make tax-favored IRA contributions or for opening IRAs for employees. A national web site would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Contributions by employees to automatic IRAs would qualify for the saver's credit to the extent the contributor and the contributions otherwise qualified.

Small employers (those that have no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable tax credit for the employer's expenses associated with the arrangement up to \$500 for the first year and \$250 for the second year. Furthermore, these employers would be entitled to an additional non-refundable credit of \$25 per enrolled employee up to \$250 for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (for example, because they have ten or fewer employees).

In conjunction with the automatic IRA proposal, to encourage employers not currently sponsoring a qualified retirement plan, SEP, or SIMPLE to do so, the non-refundable "start-up costs" tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE would be doubled from the current maximum of \$500 per year for three years to a maximum of \$1,000 per year for three years and extended to four years (rather than three) for any employer that adopts a new qualified retirement plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This expanded



“start-up costs” credit for small employers, like the current “start-up costs” credit, would not apply to automatic or other payroll deduction IRAs. The expanded credit would encourage small employers that would otherwise adopt an automatic IRA to adopt a new 401(k), SIMPLE, or other employer plan instead, while also encouraging other small employers to adopt a new employer plan.

The proposal would become effective after December 31, 2014.

## **EXPAND THE CHILD AND DEPENDENT CARE TAX CREDIT**

### **Current Law**

In 2012, taxpayers with child or dependent care expenses who are working or looking for work are eligible for a nonrefundable tax credit that partially offsets these expenses. Married couples are eligible only if they file a joint return and either both spouses are working or looking for work, or if one spouse is working or looking for work and the other is attending school full-time. To qualify for this benefit, the child and dependent care expenses must be for either (1) a child under age thirteen when the care was provided or (2) a disabled dependent of any age with the same place of abode as the taxpayer. Any allowable credit is reduced by the aggregate amount excluded from income under an employer-provided dependent care assistance program.

Eligible taxpayers may claim the credit for up to 35 percent of up to \$3,000 in eligible expenses for one child or dependent and up to \$6,000 in eligible expenses for more than one child or dependent. The percentage of expenses for which a credit may be taken decreases by 1 percentage point for every \$2,000 (or part thereof) of adjusted gross income (AGI) over \$15,000 until the percentage of expenses reaches 20 percent (at incomes above \$43,000). There are no further income limits. The phase-down point and the amount of expenses eligible for the credit are not indexed for inflation.

### **Reasons for Change**

Access to affordable child care is a barrier to employment or further schooling for some individuals. Assistance to individuals with child and dependent care expenses increases the ability of individuals to participate in the labor force or in education programs.

### **Proposal**

The proposal would permanently increase from \$15,000 to \$75,000 the AGI level at which the credit begins to phase down. The percentage of expenses for which a credit may be taken would decrease at a rate of 1 percentage point for every \$2,000 (or part thereof) of AGI over \$75,000 until the percentage reached 20 percent (at incomes above \$103,000). As under current law, there would be no further income limits and the phase-down point and the amount of expenses eligible for the credit would not be indexed for inflation.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **EXTEND EXCLUSION FROM INCOME FOR CANCELLATION OF CERTAIN HOME MORTGAGE DEBT**

### **Current Law**

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness. Exceptions to this general rule include exclusions for debtors in Title 11 bankruptcy cases, for insolvent debtors, for discharges of certain farm and non-farm business indebtedness, and for discharges of qualified principal residence indebtedness (QPRI). Most of the exceptions require taxpayers to take steps (such as reducing basis) to merely defer the income from the discharge rather than excluding it permanently. The amount of discharge generally is the excess of the adjusted issue price of the debt being discharged over the amount, if any, that the borrower uses to satisfy the debt. If a modification of indebtedness is treated as an exchange of an old debt instrument for a new one, these rules apply (as they do for all debt-for-debt exchanges). For this purpose, if the debtor issues a new debt instrument in satisfaction of the old one, the debtor is treated as having satisfied the old debt with an amount of money equal to the issue price of the new one.

QPRI is acquisition indebtedness with respect to the taxpayer's principal residence (limited to \$2 million). Acquisition indebtedness with respect to a principal residence generally means indebtedness that is incurred in the acquisition, construction, or substantial improvement of the taxpayer's principal residence and that is secured by the residence. It also includes refinancing of preexisting acquisition indebtedness to the extent the amount of the new debt does not exceed the old.

If, immediately before the discharge, only a portion of discharged indebtedness is QPRI, then the discharge is treated as applying first to the portion of the debt that is *not* QPRI, and thus the exclusion applies only to the extent that the total discharge was greater than that non-QPRI portion. The basis of the taxpayer's principal residence is reduced by the amount excluded from income under the provision.

The exclusion for discharges of QPRI was added to the Internal Revenue Code by the Mortgage Forgiveness Debt Relief Act of 2007, effective for discharges in 2007 through 2009. The Emergency Economic Stabilization Act of 2008 extended the exclusion to discharges in 2010, 2011, and 2012. The American Taxpayer Relief Act of 2012 extended the exclusion through 2013.

### **Reasons for Change**

In recent years, home values in regions across the country have fallen substantially, leaving millions of homeowners now owing more on their mortgage loans than the value of the homes securing those loans. Many homeowners are also experiencing difficulty making timely payments on their mortgage loans. In these circumstances, there is a substantial volume of foreclosures. In addition, it is often in the best interests of both the homeowner and the holder of the mortgage to avoid foreclosure in one of several ways. For example, the homeowner may sell the home for less than the amount owed on the mortgage loan, and (despite the shortfall) the

holder of the loan accepts the sales proceeds in full satisfaction of the loan. Alternatively, the homeowner may transfer title to the house to the lender in return for cancellation of the mortgage. Or, the homeowner and the holder may agree for the loan to be modified so that the homeowner can again become timely. Thus, although there has been improvement in the residential real estate market, there is still an elevated number of cases in which homeowners may have discharge of indebtedness income with respect to their home mortgage loans.

Beyond the many modifications being made without Government assistance, there are large numbers of mortgage modifications under programs run by Making Home Affordable (an official program of the U.S. Department of the Treasury), especially the Home Affordable Modification Program<sup>®</sup> (HAMP<sup>®</sup>). Facilitating home mortgage modifications remains important for the continued recovery of the residential real estate market. The importance is demonstrated by the fact that HAMP has been extended through the end of 2013. Moreover, an increased volume of non-Government-assisted modifications is likely to persist beyond that date.

Many modifications that are sufficiently significant to be treated as debt-for-debt exchanges involve cancellation of some portion of the debt. In most cases, exclusion of the discharge of QPRI prevents tax consequences from complicating and possibly deterring these modifications. Because of the continued importance of facilitating home mortgage modifications, the currently scheduled expiration for the exclusion of discharges of QPRI should be delayed.

### **Proposal**

The exclusion for income from the discharge of QPRI would be extended to amounts that are discharged before January 1, 2016, and to amounts that are discharged pursuant to an arrangement entered before that date. Thus, for example, the exclusion could apply to delayed discharges that occur after trial periods that began before January 1, 2016.

## **PROVIDE EXCLUSION FROM INCOME FOR STUDENT LOAN FORGIVENESS FOR STUDENTS IN CERTAIN INCOME-BASED OR INCOME-CONTINGENT REPAYMENT PROGRAMS WHO HAVE COMPLETED PAYMENT OBLIGATIONS**

### **Current Law**

In general, loan amounts that are forgiven are considered gross income to the borrower and subject to individual income tax in the year of discharge. Exceptions exist for certain student loan repayment programs. Specifically, students who participate in the National Health Service Corps Loan Repayment program, certain state loan repayment programs, and certain profession-based loan programs may exclude discharged amounts from gross income.

Students with higher education expenses may be eligible to borrow money for their education through the Federal Direct Loan Program. Prior to July 1, 2010, they may also have been eligible to borrow money through the Federal Family Education Loan Program. Both programs are administered by the Department of Education. These programs provide borrowers with options for repaying their loans that are related to the borrowers' income after completing their educations (the income-contingent and the income-based repayment options). Under these options a borrower completes the repayment obligation when he or she has repaid the loan in full, with interest, or has made all payments that are required under the terms of the plan. For borrowers who reach this point, any remaining loan balance is forgiven. Under current law, any debt forgiven by these programs is considered gross income to the borrower and thus subject to individual income tax.

### **Reasons for Change**

At the time the loans are forgiven, the individuals who have met the requirements for debt forgiveness in the income-contingent and the income-based repayment programs would have been making payments for many years. In general, these individuals will have had low incomes relative to their debt burden for much or all of this time. For many of these individuals, paying the tax on the forgiven amounts will be difficult. Furthermore, the potential tax consequence may be making some student loan borrowers reluctant to avail themselves of these loan repayment options.

### **Proposal**

The proposal would exclude from gross income amounts forgiven at the end of the repayment period for certain borrowers using the income-contingent repayment option or the income-based repayment option.

The provision would be effective for loans forgiven after December 31, 2013.

## **PROVIDE EXCLUSION FROM INCOME FOR STUDENT LOAN FORGIVENESS AND FOR CERTAIN SCHOLARSHIP AMOUNTS FOR PARTICIPANTS IN THE INDIAN HEALTH SERVICE (IHS) HEALTH PROFESSIONS PROGRAMS**

### **Current Law**

Gross income generally does not include certain scholarship amounts that are used to pay tuition, required fees, and related expenses (e.g., books, certain computing equipment, fees, and supplies). Amounts for other expenses, including child care and travel not incidental to the scholarship, are included in income. However, if the scholarship represents payment for teaching, research, or other services required as a condition for receiving the scholarship, including a future work obligation, the scholarship is considered ordinary income (i.e., wages) and is thus taxable. An exception to this rule exists for recipients of National Health Service Corp (NHSC) scholarships and Armed Forces Health Professions scholarships. (Scholarship amounts used to pay nonqualified expenses are taxable as ordinary income.)

In most cases, loan amounts forgiven or repaid on an individual's behalf are considered ordinary income and thus, are taxable. However, certain student loan debt that is forgiven or cancelled is excluded from income. This includes debt repaid under the NHSC Loan Repayment Program and under certain state programs intended to increase the availability of health care services in underserved areas.

The IHS Health Professions Scholarship Program and IHS Loan Forgiveness Program improve access to medical care for Indian and Alaska Natives by providing physicians and other health professionals to IHS facilities. Participants in the scholarship program commit to a term of employment at IHS facilities upon completion of their training. Participants in the loan repayment program serve at IHS facilities in exchange for loan repayment. Similarly, NHSC participants commit to employment at approved facilities that provide health care to underserved populations in exchange for scholarship funds and/or repayment of their student loans. IHS facilities are approved locations for NHSC participants.

### **Reasons for Change**

The IHS Health Professions Scholarship and IHS Loan Forgiveness Program are very similar to other programs that receive preferred tax treatment, and therefore should receive the same tax treatment.

### **Proposal**

The proposal would allow scholarship funds for qualified tuition and related expenses received under the IHS Health Professions Scholarship program to be excluded from income, even though recipients incur a work requirement. Furthermore, the proposal would allow participants in the IHS Loan Repayment Program to exclude from income student loan amounts that are forgiven by the IHS Loan Repayment program. The proposal would apply exclusively to the programs described in Section 104 and 108 of the Indian Health Care Improvement Act (Public Law 94-437). The tax treatment of all other IHS programs would be unchanged.

The proposal would be effective for tax years beginning after December 31, 2013.

## **UPPER-INCOME TAX PROVISIONS**

### **REDUCE THE VALUE OF CERTAIN TAX EXPENDITURES**

#### **Current Law**

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income (AGI), and claiming either itemized deductions or a standard deduction. The tax reduction from the last dollar excluded or deducted is \$1.00 times the taxpayer's marginal income tax rate (e.g., if the marginal tax rate were 39.6 percent, then the tax value of the last dollar deducted would be 39.6 cents).

Certain types of income are excluded permanently or deferred temporarily from income subject to tax. These items include interest on State or local bonds, amounts paid by employers and employees for employer-sponsored health coverage, contributions to health savings accounts and Archer MSAs, amounts paid by employees and employers for defined contribution retirement plans, certain premiums for health insurance for self-employed individuals, certain income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, interest on education loans, and certain higher education expenses.

Individual taxpayers may elect to itemize their deductions instead of claiming a standard deduction. In general, itemized deductions include medical and dental expenses (in excess of 7.5 percent of AGI in 2013 for taxpayers age 65 or over and 10 percent of AGI for other taxpayers), state and local property taxes and income taxes (and, in 2013 sales taxes), interest paid, gifts to charities, casualty and theft losses (in excess of 10 percent of AGI), job expenses and certain miscellaneous expenses (some only in excess of 2 percent of AGI).

For higher-income taxpayers, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) are reduced if AGI exceeds a statutory floor that is indexed annually for inflation (so called Pease limitation).

#### **Reasons for Change**

Increasing the income tax liability of higher-income taxpayers would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels. In particular, limiting the value of tax expenditures including itemized deductions, certain exclusions in income subject to tax, and certain deductions in the computation of AGI, would reduce the benefit that high-income taxpayers receive from those tax expenditures and help close the gap between the value of these tax expenditures for high-income Americans and the value for middle-class Americans.

#### **Proposal**

The proposal would limit the tax value of specified deductions or exclusions from AGI and all itemized deductions. This limitation would reduce the value to 28 percent of the specified



exclusions and deductions that would otherwise reduce taxable income in the 33-percent, 35-percent, or 39.6-percent tax brackets. A similar limitation also would apply under the alternative minimum tax.

The income exclusions and deductions limited by this provision would include any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade or business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans, and certain higher education expenses.

The proposal would apply to itemized deductions after they have been reduced by the statutory limitation on certain itemized deductions for higher-income taxpayers. If a deduction or exclusion for contributions to retirement plans or individual retirement arrangements is limited by this proposal, then the taxpayer's basis will be adjusted to reflect the additional tax imposed.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **IMPLEMENT THE BUFFETT RULE BY IMPOSING A NEW “FAIR SHARE TAX”**

### **Current Law**

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income (AGI), and claiming either itemized deductions or a standard deduction. Major exclusions include the value of health insurance premiums paid by employers and interest on tax-exempt bonds. Major itemized deductions include those for State and local taxes and for home mortgage interest.

Qualified dividends and long-term capital gains are taxed at a maximum rate of 23.8 percent, while ordinary income, including wages, is taxed at graduated rates that rise as high as 39.6 percent. In addition, wages and self-employment earnings are subject to payroll taxes as high as 15.3 percent (7.65 percent each for employee and employer), but average and marginal payroll tax rates are much lower for higher-income families, because the wage base for much of the payroll tax is capped at \$113,700 in 2013.

### **Reasons for Change**

Deductions can significantly reduce tax liability for high-income taxpayers. For example, under current law, over 10 percent of itemized deductions would accrue to the top 0.1 percent of families in 2014. Higher-income families also face lower payroll tax rates than do middle income families.

In addition, many high-income taxpayers derive large benefits from the preferentially low tax rates on dividends and capital gains. For example, nearly 90 percent of families in the top 0.1 percent of the income distribution benefit from the lower tax rate on dividends and capital gains, compared to less than 10 percent of families in the bottom 60 percent of the income distribution. High-income investors, who have large amounts of dividends and capital gains, can have tax burdens that are much lower than those paid by equally well-off high-income workers. In addition, the maximum 23.8 percent tax rate on dividends and capital gains is well below the statutory tax rates on wages faced by many lower-income families. Consequently, a high-income taxpayer whose income is largely derived from capital gains or dividend income may have a lower average tax rate than a lower-income taxpayer whose income is largely or exclusively derived from wages.

Increasing the income tax liability of higher-income taxpayers with relatively low tax burdens would reduce the deficit, make the tax system more progressive, and distribute the cost of government more fairly among taxpayers.

### **Proposal**

The proposal would impose a new minimum tax, called the Fair Share Tax (FST), on high-income taxpayers. The tentative FST equals 30 percent of AGI less a credit for charitable contributions. The charitable credit equals 28 percent of itemized charitable contributions

allowed after the overall limitation on itemized deductions (so called Pease limitation). The final FST is the excess, if any, of the tentative FST over regular income tax (after certain credits, the alternative minimum tax and the 3.8 percent surtax on investment income) and the employee portion of payroll taxes. The set of certain credits subtracted from regular income tax excludes the foreign tax credit, the credit for tax withheld on wages, and the credit for certain uses of gasoline and special fuels.

The amount of FST payable (i.e., the excess of tentative FST over regular tax) is phased in linearly starting at \$1 million of AGI (\$500,000 in the case of a married individual filing a separate return). The FST is fully phased in at \$2 million of AGI (\$1 million in the case of a married individual filing a separate return). For example, if a single taxpayer had AGI of \$1.25 million, tentative FST of \$375,000 and regular tax of \$250,000, his payable FST would be  $((\$1.25-\$1.00)/(\$2.00-\$1.00)) * (\$375,000-\$250,000) = \$31,250$ . The AGI thresholds are indexed for inflation beginning after 2014.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **MODIFY ESTATE AND GIFT TAX PROVISIONS**

### **RESTORE THE ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER (GST) TAX PARAMETERS IN EFFECT IN 2009**

#### **Current Law**

The current estate, GST, and gift tax rate is 40 percent, and each individual has a lifetime exclusion for all three types of taxes of \$5 million (indexed after 2011 for inflation from 2010). The surviving spouse of a person who dies after December 31, 2010, may be eligible to increase the surviving spouse's exclusion amount for estate and gift tax purposes by the portion of the predeceased spouse's exclusion that remained unused at the predeceased spouse's death (in other words, the exclusion is "portable").

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the maximum tax rate was 55 percent, plus a 5-percent surcharge on the amount of the taxable estate between approximately \$10 million and \$17.2 million (designed to recapture the benefit of the lower rate brackets). The exclusion for estate and gift tax purposes was \$675,000 and was scheduled to increase to \$1 million by 2006. Under EGTRRA, beginning in 2002, the top tax rate for all three types of taxes was reduced incrementally until it was 45 percent in 2007. In 2004, the exemption for estate taxes (but not for gift taxes) began to increase incrementally until it was \$3.5 million in 2009, and the GST tax exemption and rate became unified with the estate tax exemption and rate. During this post-EGTRRA period through 2009, the gift tax exemption remained \$1 million. Under EGTRRA, for 2010, the estate tax was to be replaced with carryover basis treatment of bequests, the GST tax was to be not applicable, and the gift tax was to remain in effect with a \$1 million exclusion and a 35-percent tax rate. The EGTRRA provisions were scheduled to expire at the end of 2010, meaning that the estate tax and GST tax would be inapplicable for only one year.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRUIRJCA) retroactively changed applicable law for 2010 by providing a top estate tax rate of 35 percent for taxpayers electing estate tax rather than carryover-basis treatment. It retroactively reinstated the GST tax and unified the exemption for estate, GST, and gift taxes beginning in 2011 with a \$5 million total lifetime exclusion for all three taxes (indexed after 2011 for inflation from 2010). It also enacted the portability of the exemption between spouses for both gift and estate tax purposes. The TRUIRJCA provisions were scheduled to expire at the end of 2012.

The American Taxpayer Relief Act of 2012 (ATRA) permanently raised the top tax rate for estate, GST, and gift taxes to 40 percent. It also made permanent all the substantive estate, GST and gift tax provisions as in effect during 2012.

#### **Reasons for Change**

ATRA retained a substantial portion of the tax cut provided to the most affluent taxpayers under TRUIRJCA that we cannot afford to continue. We need an estate tax law that is fair and raises an appropriate amount of revenue.

## **Proposal**

Beginning in 2018, the proposal would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45 percent and the exclusion amount would be \$3.5 million for estate and GST taxes, and \$1 million for gift taxes. There would be no indexing for inflation. The proposal would confirm that, in computing gift and estate tax liabilities, no estate or gift tax would be incurred by reason of decreases in the applicable exclusion amount with respect to a prior gift that was excluded from tax at the time of the transfer. Finally, portability of unused estate and gift tax exclusions between spouses would be allowed.

The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2017.

## **REQUIRE CONSISTENCY IN VALUE FOR TRANSFER AND INCOME TAX PURPOSES**

### **Current Law**

Section 1014 provides that the basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Similarly, property included in the decedent's gross estate for estate tax purposes generally must be valued at its fair market value on the date of death. Although the same valuation standard applies to both provisions, current law does not explicitly require that the recipient's basis in that property be the same as the value reported for estate tax purposes.

Section 1015 provides that the donee's basis in property received by gift during the life of the donor generally is the donor's adjusted basis in the property, increased by gift tax paid on the transfer. If, however, the donor's basis exceeds the fair market value of the property on the date of the gift, the donee's basis is limited to that fair market value for purposes of determining any subsequent loss.

Section 1022, applicable to the estates of decedents dying during 2010 if a timely election to that effect was made, provides that the basis of property acquired from such a decedent is the lesser of the fair market value of the property on the decedent's date of death, or the decedent's adjusted basis in that property as increased by the additional basis (if any) allocated to that property by the executor under section 1022.

Section 6034A imposes a consistency requirement – specifically, that the recipient of a distribution of income from a trust or estate must report on the recipient's own income tax return the exact information included on the Schedule K-1 of the trust's or estate's income tax return – but this provision applies only for income tax purposes, and the Schedule K-1 does not include basis information.

### **Reasons for Change**

Taxpayers should be required to take consistent positions in dealing with the Internal Revenue Service. The basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Consistency requires that the same value be used by the recipient (unless that value is in excess of the accurate value). In the case of property transferred on death or by gift during life, often the executor of the estate or the donor, respectively, will be in the best position to ensure that the recipient receives the information that will be necessary to accurately determine the recipient's basis in the transferred property.

### **Proposal**

The proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death under section 1014 must equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor must equal the donor's basis determined under section 1015. The basis of property acquired from a

decedent to whose estate section 1022 is applicable is the basis of that property, including any additional basis allocated by the executor, as reported on the Form 8939 that the executor filed. The proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments).

A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary valuation and basis information to both the recipient and the Internal Revenue Service.

A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

The proposal would be effective for transfers on or after the date of enactment.

## **REQUIRE A MINIMUM TERM FOR GRANTOR RETAINED ANNUITY TRUSTS (GRATS)**

### **Current Law**

Section 2702 provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a “qualified interest.” A fixed annuity, such as the annuity interest retained by the grantor of a GRAT, is one form of qualified interest, so the gift of the remainder interest in the GRAT is determined by deducting the present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust.

Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries, who generally are descendants of the grantor. If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor’s gross estate for estate tax purposes. To this extent, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

### **Reasons for Change**

GRATs have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, providing that the grantor survives the GRAT term and the trust assets do not depreciate in value. The greater the appreciation, the greater the transfer tax benefit achieved. Taxpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor’s death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

### **Proposal**

The proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent “zeroing-out” the gift tax value of the remainder interest, it would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit.

The proposal would apply to trusts created after the date of enactment.



## **LIMIT DURATION OF GENERATION-SKIPPING TRANSFER (GST) TAX EXEMPTION**

### **Current Law**

GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor. The GST tax was enacted to prevent the avoidance of estate and gift taxes through the use of a trust that gives successive life interests to multiple generations of beneficiaries. In such a trust, no estate tax would be incurred as beneficiaries died, because their respective life interests would die with them and thus would cause no inclusion of the trust assets in the deceased beneficiary's gross estate. The GST tax is a flat tax on the value of a transfer at the highest estate tax bracket applicable in that year. Each person has a lifetime GST tax exemption (\$5.25 million in 2013) that can be allocated to transfers made, whether directly or in trust, by that person to a grandchild or other "skip person." The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of the transfer or trust assets equal to the amount of GST exemption allocated, but also all appreciation and income on that amount during the existence of the trust.

### **Reasons for Change**

At the time of the enactment of the GST provisions, the law of most (all but about three) states included the common law Rule Against Perpetuities (RAP) or some statutory version of it. The RAP generally requires that every trust terminate no later than 21 years after the death of a person who was alive (a life in being) at the time of the creation of the trust.

Many states now either have repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. (A trust may be situated anywhere; a grantor is not limited to the jurisdiction of the grantor's domicile for this purpose.) As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with \$1 million (the exemption at the time of enactment of the GST tax) and a maximum duration limited by the RAP, to trusts funded with \$5.25 million and continuing (and growing) in perpetuity.

### **Proposal**

The proposal would provide that, on the 90<sup>th</sup> anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts will be deemed to have the same date of creation as the initial trust, with one exception, as follows. If, prior to the 90<sup>th</sup> anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as

described in section 2642(c)(2), the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary's share to continue to be held in trust without incurring GST tax on distributions to that beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on that beneficiary's death will be included in that beneficiary's gross estate for Federal estate tax purposes. The other rules of section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90<sup>th</sup> anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision.

The proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).

## **COORDINATE CERTAIN INCOME AND TRANSFER TAX RULES APPLICABLE TO GRANTOR TRUSTS**

### **Current Law**

A grantor trust is a trust, whether revocable or irrevocable, of which an individual is treated as the owner for income tax purposes. For income tax purposes, a grantor trust is taxed as if the grantor or another person owns the trust assets directly, and the deemed owner and the trust are treated as the same person. Thus, transactions between the trust and the deemed owner are ignored. For transfer tax purposes, however, the trust and the deemed owner are separate persons, and under certain circumstances, the trust is not included in the deemed owner's gross estate for estate tax purposes at the death of the deemed owner.

### **Reasons for Change**

The lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences.

### **Proposal**

If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner. The proposal would reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts; grantor retained annuity trusts; personal residence trusts; and qualified personal residence trusts. Similarly, it would not apply to any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor. It also would not apply to any trust that is a grantor trust solely by reason of section 677(a)(3).

The proposal would be effective with regard to trusts that engage in a described transaction on or after the date of enactment. Regulatory authority would be granted, including the ability to create exceptions to this provision.

## **EXTEND THE LIEN ON ESTATE TAX DEFERRALS PROVIDED UNDER SECTION 6166 OF THE INTERNAL REVENUE CODE**

### **Current Law**

Section 6166 of the Internal Revenue Code allows the deferral of estate tax on certain closely held business interests for up to fourteen years from the (unextended) due date of the estate tax payment (up to fifteen years and three months from date of death). This provision was enacted to reduce the possibility that the payment of the estate tax liability could force the sale or failure of the business. Section 6324(a)(1) imposes a lien on estate assets generally for the ten-year period immediately following the decedent's death to secure the full payment of the estate tax. Thus, the estate tax lien under section 6324(a)(1) expires approximately five years before the due date of the final payment of the deferred estate tax under section 6166.

### **Reasons for Change**

In many cases, the Internal Revenue Service (IRS) has had difficulty collecting the deferred estate tax, often because of business failures during that tax deferral period. The IRS sometimes requires either an additional lien or some form of security, but these security interests generally are prohibitively expensive and damaging to the day-to-day conduct and financing of the business. In addition, unless these other security measures are put in place toward the beginning of the deferral period, there is a risk that other creditors could have a higher priority interest than the Government. This proposal is expected to substantially eliminate the need for IRS to determine whether and when additional security is needed, and the significant burdens on the closely held business from having to provide such additional security.

### **Proposal**

The proposal would extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period.

The proposal would be effective for the estates of all decedents dying on or after the date of enactment, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not then expired.

## **CLARIFY GENERATION-SKIPPING TRANSFER (GST) TAX TREATMENT OF HEALTH AND EDUCATION EXCLUSION TRUSTS (HEETS)**

### **Current Law**

Payments made by a donor directly to the provider of medical care for another person or directly to a school for another person's tuition are exempt from gift tax under section 2503(e). For purposes of the GST tax, section 2611(b)(1) excludes "any transfer which, if made during the donor's life, would not be treated as a taxable gift by reason of section 2503(e)." Thus, direct payments made during life by an older generation donor for the payment of these qualifying expenses for a younger generation beneficiary are exempt from both gift and GST taxes.

### **Reasons for Change**

Some taxpayers have interpreted the language of section 2611(b)(1) as permitting the avoidance of GST tax through the use of a trust known as a HEET. A HEET provides for the medical expenses and tuition of multiple generations of descendants. Taxpayers using this technique take the position that section 2611(b)(1) exempts these trust distributions from GST tax (generally, in perpetuity) because the distributions are used for the payment of medical care expenses and tuition. The substantial amounts contributed to HEETs will appreciate in these trusts, and taxpayers claim that no estate, gift, or GST tax will ever be incurred after the initial funding of these trusts.

The intent of section 2611(b)(1) is to exempt from GST tax only those payments that are not subject to gift tax, that is, payments made by a living donor directly to the provider of medical care for another person or directly to a school for another person's tuition.

### **Proposal**

The proposal would clarify that the exclusion from the definition of a GST under section 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes.

The proposal would apply to trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.

## REFORM TREATMENT OF FINANCIAL INDUSTRY INSTITUTIONS AND PRODUCTS

### **IMPOSE A FINANCIAL CRISIS RESPONSIBILITY FEE**

#### **Current Law**

There is no sector-specific Federal tax applied to financial firms (although these firms are subject to the general corporate income tax and potentially a wide range of excise taxes). Financial sector firms are subject to a range of fees, depending on the lines of business in which they participate. For example, banks are assessed fees by the Federal Deposit Insurance Corporation to cover the costs of insuring deposits made at these institutions.

#### **Reasons for Change**

Excessive risk undertaken by major financial firms was a significant cause of the recent financial crisis. Extraordinary steps were taken by the Federal government to inject funds into the financial system, guarantee certain types of securities, and purchase securities from weakened firms. The law that enabled some of these actions and that created the Troubled Asset Relief Program (TARP) requires the President to propose an assessment on the financial sector to pay back the costs of these extraordinary actions. Accordingly, the Financial Crisis Responsibility Fee is intended to recoup the costs of the TARP program as well as discourage excessive risk-taking, as the combination of high levels of risky assets and less stable sources of funding were key contributors to the financial crisis. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders and similar to fees that have been adopted or proposed by other countries.

#### **Proposal**

The Financial Crisis Responsibility Fee would be assessed on certain liabilities of the largest firms in the financial sector. Specific components of the proposal are described below.

**Firms Subject to the Fee:** The fee would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control certain broker-dealers, and insured depository institutions. U.S. companies owning or controlling these types of entities as of January 14, 2010 also would be subject to the fee. Firms with worldwide consolidated assets of less than \$50 billion would not be subject to the fee for the period when their assets are below this threshold. U.S. subsidiaries of foreign firms that fall into these categories and that have assets in excess of \$50 billion also would be covered.

**Base of Fee:** The fee would be based on the covered liabilities of a financial firm. Covered liabilities are generally the consolidated risk-weighted assets of a financial firm, less its capital, insured deposits, and certain loans to small business. These would be computed using information filed with the appropriate Federal or State regulators. For insurance companies, certain policy reserves and other policyholder obligations also would be deducted in computing covered liabilities. In addition, adjustments would be provided to prevent avoidance.

**Fee Rates:** The rate of the fee applied to covered liabilities would be 17 basis points. A 50-percent discount would apply to more stable sources of funding, including long-term liabilities.

**Deductibility:** The fee would be deductible in computing corporate income tax.

**Filing and Payment Requirements:** A financial entity subject to the fee would report it on its annual Federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

The fee would be effective as of January 1, 2015.



## **REQUIRE CURRENT INCLUSION IN INCOME OF ACCRUED MARKET DISCOUNT AND LIMIT THE ACCRUAL AMOUNT FOR DISTRESSED DEBT**

### **Current Law**

Market discount is generally the difference between a bond's acquisition price and its stated redemption price at maturity. In most instances, market discount arises when a bond is purchased in the secondary market for a price less than its principal amount (or its adjusted issue price in the case of a bond originally issued at a discount). Market discount is generally created when interest rates increase after a bond is issued, the creditworthiness of the issuer declines, or both of these events occur.

Market discount that accrues while a taxpayer holds a bond is treated as ordinary income, and taxed when the bond matures or the taxpayer otherwise disposes of it. The amount of accrued market discount treated as ordinary income is limited to the amount of gain recognized on the disposition of the bond. A partial principal payment on a bond also causes accrued market discount to be recognized. Market discount accrues on a ratable basis unless the taxpayer elects to accrue on the basis of a constant interest rate.

### **Reasons for Change**

Market discount generated by a change in interest rates, or by a decrease in an issuer's creditworthiness, is economically similar to original issue discount (OID). Unlike market discount, however, OID is includible in income of the holder currently using a constant interest rate. Given the economic similarities between market discount and OID, the tax treatment should also be aligned.

Including market discount in income annually has previously been complicated by the fact that each purchaser of debt may have an amount of market discount that differs from other purchasers because the debt will be purchased at different times and for different prices. Moreover, historically market discount has not been reportable by brokers. New information reporting rules, however, will require that market discount be reported along with basis and other information with respect to a debt instrument. Once information reporting for debt instruments goes into effect, market discount will be reported to holders on their annual information returns.

### **Proposal**

The proposal would require taxpayers to take accrued market discount into income currently, in the same manner as OID. To prevent over-accrual of market discount on distressed debt, the accrual would be limited to the greater of (1) an amount equal to the bond's yield to maturity at issuance plus 5 percentage points, or (2) an amount equal to the applicable federal rate plus 10 percentage points.

The proposal would apply to debt securities acquired after December 31, 2013.

## **REQUIRE THAT THE COST BASIS OF PORTFOLIO STOCK THAT IS A COVERED SECURITY MUST BE DETERMINED USING AN AVERAGE BASIS METHOD**

### **Current Law**

Gain or loss generally is recognized for Federal income tax purposes when it is realized (typically, when property is sold). A taxpayer's gain or loss on the disposition of property is the difference between the amount realized and the property's adjusted basis. To compute adjusted basis, a taxpayer first determines the property's unadjusted or original basis and then makes any adjustments prescribed by the Internal Revenue Code (Code). The original basis of property is its cost, except as otherwise determined under the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange).

When a taxpayer sells or otherwise disposes of identical shares of stock that have different cost basis, current regulations permit the taxpayer to identify the specific shares of stock sold. This "specific identification" method allows a taxpayer to determine the amount of gain or loss to recognize on the disposition by choosing among identical shares of stock with different cost bases.

### **Reasons for Change**

The use of specific identification allows taxpayers to manipulate recognition of gain or loss on fungible shares of portfolio stock. Once portfolio stock has acquired a long-term holding period, it becomes economically indistinguishable from other identical shares held long term by the taxpayer, and it should be treated accordingly for tax purposes.

### **Proposal**

The proposal would require the use of average basis for all identical shares of portfolio stock held by a taxpayer that have a long-term holding period. Thus, the provision would require that the cost of any portfolio stock sold, exchanged, or otherwise disposed of be determined in accordance with the average basis method now permitted for regulated investment company stock. The provision would apply to all identical shares of portfolio stock held by the taxpayer, including identical shares of portfolio stock held by the taxpayer in separate accounts with the same broker or with different brokers. Shares held by a taxpayer in a nontaxable account, however, such as an individual retirement account, would not be subject to the requirement to use average basis. The statute would provide the Secretary with authority to draft regulations applying the average basis method to stock other than portfolio stock. Special rules may also be required to coordinate the average basis method with the rules applicable to stock in a passive foreign investment company.

The proposal would apply to portfolio stock acquired on or after January 1, 2014.

## **OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS**

### **INCREASE OIL SPILL LIABILITY TRUST FUND FINANCING RATE BY ONE CENT AND UPDATE THE LAW TO INCLUDE OTHER SOURCES OF CRUDES**

#### **Current Law**

An excise tax is imposed on: (1) crude oil received at a U.S. refinery; (2) imported petroleum products (including crude oil) entered into the United States for consumption, use, or warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil. The tax is eight cents per barrel for periods before January 1, 2017, and 9 cents per barrel for periods after December 31, 2016. Crudes such as those that are produced from bituminous deposits as well as kerogen-rich rock are not treated as crude oil or petroleum products for purposes of the tax. The tax is deposited in the Oil Spill Liability Trust Fund to pay costs associated with oil removal and damages resulting from oil spills, as well as to provide annual funding to certain agencies for a wide range of oil pollution prevention and response programs, including research and development. In the case of an oil spill, the fund makes it possible for the Federal government to pay for removal costs up front, and then seek full reimbursement from the responsible parties.

#### **Reasons for Change**

The Deepwater Horizon oil spill was the worst oil spill in American history, releasing nearly 5 million barrels of oil into the Gulf of Mexico, and led to the nation's largest oil spill response. The magnitude of the Federal response reinforced the importance of the Oil Spill Liability Trust Fund and the need to maintain a sufficient balance, particularly in order to accommodate spills of national significance. In addition to increasing the rate of tax, it is appropriate to extend the tax to other sources of crudes that present environmental risks comparable to those associated with crude oil and petroleum products.

#### **Proposal**

The proposal would increase the rate of the Oil Spill Liability Trust Fund tax to 9 cents per barrel for periods after December 31, 2013, and to 10 cents per barrel for periods after December 31, 2017. In addition, the proposal would extend the tax to crudes such as those produced from bituminous deposits as well as kerogen-rich rock. The Superfund tax, which would be reinstated under a proposal discussed elsewhere in this volume, would also be imposed on these substances. The tax would be imposed at the applicable rate on such crudes received at a U.S. refinery, entered into the United States, or used or exported as described above after December 31, 2013.

## **REINSTATE AND EXTEND SUPERFUND EXCISE TAXES**

### **Current Law**

The following Superfund excise taxes were imposed before January 1, 1996:

- (1) An excise tax on domestic crude oil and on imported petroleum products at a rate of 9.7 cents per barrel;
- (2) An excise tax on listed hazardous chemicals at a rate that varied from 22 cents to \$4.87 per ton; and
- (3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2) above.

Amounts equivalent to the revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

### **Reasons for Change**

The Superfund excise taxes should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances. In addition, it is appropriate to extend the tax to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock.

### **Proposal**

The proposal would reinstate the three Superfund excise taxes for periods after December 31, 2013 and before January 1, 2024. In addition, the proposal would extend the excise tax on domestic crude oil and imported petroleum products to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock. Under a proposal discussed elsewhere in this volume, the Oil Spill Liability Trust Fund tax would also be imposed on these substances.

## **REINSTATE SUPERFUND ENVIRONMENTAL INCOME TAX**

### **Current Law**

For taxable years beginning before January 1, 1996, a corporate environmental income tax was imposed at a rate of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded \$2 million. Modified alternative minimum taxable income was defined as a corporation's alternative minimum taxable income, determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax.

The tax was dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

### **Reasons for Change**

The corporate environmental income tax should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances where no viable, liable party has been identified.

### **Proposal**

The proposal would reinstate the corporate environmental income tax for taxable years beginning after December 31, 2013 and before January 1, 2024.

## **INCREASE TOBACCO TAXES AND INDEX FOR INFLATION**

### **Current Law**

Tobacco products are taxed at rates set in 2009 as part of the Children's Health Insurance Program Reauthorization Act. These rates impose a tax of \$50.33 per 1,000 cigarettes (or just over \$1.00 per pack), as well as taxes on other tobacco products. These tax rates are not indexed for inflation.

### **Reasons for Change**

Despite strong evidence of the negative health effects of tobacco use more than 14 billion packs of cigarettes were sold in the U.S in 2011. The Centers for Disease Control estimates that there are roughly 443,000 smoking related deaths annually and 8.6 million individuals suffer from smoking-related illnesses each year. Excise taxes, levied on manufacturers and importers of tobacco products, are one of the main ways that policymakers can affect tobacco production and consumption. Studies have shown that these taxes can decrease harmful consumption and improve health substantially. Taxes on tobacco products are also a relatively efficient way to generate revenue for important national priorities, such as providing high-quality preschool.

### **Proposal**

The proposal would increase the tax on cigarettes from just under \$1.01 per pack to about \$1.95 per pack and increase all other excise taxes on tobacco products and cigarette papers and tubes by roughly the same proportion beginning in 2014. Excise tax rates would be increased for inflation annually.

The proposal includes a one-time floor stocks tax that generally applies to tobacco products, cigarette papers, and tubes that are held for sale on January 1, 2014. Because large cigars are taxed as a percentage of price, rather than per cigar, administering a floor tax on them would be difficult, so large cigars are exempted from the floor tax. No other tobacco products are exempted from the floor tax. The floor stocks tax is payable on or before April 1, 2014.

The Administration also proposes to clarify that roll-your-own tobacco includes any processed tobacco that is removed or transferred for delivery to anyone without a proper permit, but does not include export shipments of processed tobacco.

The proposal would be effective for articles removed after December 31, 2013.

## **MAKE UNEMPLOYMENT INSURANCE SURTAX PERMANENT**

### **Current Law**

The Federal Unemployment Tax Act (FUTA) currently imposes a Federal payroll tax on employers of 6.0 percent of the first \$7,000 paid annually to each employee. The tax funds a portion of the Federal/State unemployment benefits system. States also impose an unemployment tax on employers. Employers in States that meet certain Federal requirements are allowed a credit for State unemployment taxes of up to 5.4 percent, making the minimum net Federal tax rate 0.6 percent. Generally, Federal and State unemployment taxes are collected quarterly and deposited in Federal trust fund accounts.

Before July 1, 2011, the Federal payroll tax had included a temporary surtax of 0.2 percent, which was added to the permanent FUTA tax rate. The surtax had been extended several times since its enactment in 1976, but it expired on July 1, 2011.

### **Reasons for Change**

Reinstating the surtax will support the continued solvency of the Federal unemployment trust funds.

### **Proposal**

The proposal would reinstate the 0.2 percent surtax and make it permanent.

The proposal would be effective for wages paid on or after January 1, 2014.

## **PROVIDE SHORT-TERM TAX RELIEF TO EMPLOYERS AND EXPAND FEDERAL UNEMPLOYMENT TAX ACT (FUTA) BASE**

### **Current Law**

The FUTA currently imposes a Federal payroll tax on employers of 6.0 percent of the first \$7,000 paid annually to each employee. Generally, these funds support the administrative costs of the unemployment insurance (UI) benefits system. Employers in States that meet certain Federal requirements are allowed a credit against FUTA taxes of up to 5.4 percent, making the minimum net Federal rate 0.6 percent. States that become non-compliant are subject to a reduction in FUTA credit, causing employers to face a higher Federal UI tax.

Each State also imposes an unemployment insurance tax on employers to fund its State UI trust fund. State UI trust funds are used to pay unemployment benefits. When State trust funds are exhausted, States borrow from the Federal UI trust fund to pay for unemployment benefits. States that borrow from the Federal UI trust fund are required to pay back the borrowed amount including interest. This debt is partly repaid by increases in the Federal UI tax (reductions in the credit) on employers in these States.

### **Reasons for Change**

In aggregate, States entered the recent recession with extremely low levels of reserves in their trust funds. Partly because of this, States have accrued large amounts of debt to the Federal UI trust fund. Employers in indebted States face immediate tax increases to repay these debts. These tax increases may discourage job creation at a time when growth is needed. At the same time, many States do not have a long-term plan to restore solvency to their trust funds. Short-term relief from State debt burdens coupled with longer-term increases in States' minimum taxable wage base will encourage economic growth and lead many States to more rapidly repay the debts they owe, restoring solvency to the UI system.

### **Proposal**

The proposal would provide short-term relief to employers by suspending interest payments on State UI debt and suspending the FUTA credit reduction for employers in borrowing States in 2013 and 2014. The proposal would also raise the FUTA wage base in 2016 to \$15,000 per worker paid annually, index the wage base to wage growth for subsequent years, and reduce the net Federal UI tax from 0.8 percent (after the proposed permanent reenactment and extension of the FUTA surtax) to 0.37 percent. States with wage bases below \$15,000 would need to conform to the new FUTA base. States would maintain the ability to set their own tax rates, as under current law.

The proposal would be effective upon the date of enactment.



## **TAX CARRIED (PROFITS) INTERESTS AS ORDINARY INCOME**

### **Current Law**

A partnership is not subject to Federal income tax. Instead, an item of income or loss of the partnership retains its character and flows through to the partners, who must include such item on their tax returns. Generally, certain partners receive partnership interests in exchange for contributions of cash and/or property, while certain partners (not necessarily other partners) receive partnership interests, typically interests in future profits (“profits interests” or “carried interests”), in exchange for services. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest, whether it was received in exchange for property, cash, or services, is generally treated as capital gain.

Under current law, income attributable to a profits interest of a general partner is generally subject to self-employment tax, except to the extent the partnership generates types of income that are excluded from self-employment taxes, e.g., capital gains, certain interest, and dividends.

### **Reasons for Change**

Although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services. A service provider’s share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service partners to receive capital gains treatment on labor income without limit, the current system creates an unfair and inefficient tax preference. The recent explosion of activity among large private equity firms and hedge funds has increased the breadth and cost of this tax preference, with some of the highest-income Americans benefiting from the preferential treatment.

### **Proposal**

The proposal would tax as ordinary income a partner’s share of income on an “investment services partnership interest” (ISPI) in an investment partnership, regardless of the character of the income at the partnership level. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains. In addition, the proposal would require the partner to pay self-employment taxes on such income. In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, this proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain. To ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

An ISPI is a carried interest in an investment partnership that is held by a person who provides services to the partnership. A partnership is an investment partnership if substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business. To the extent (1) the partner who holds an ISPI contributes "invested capital" (which is generally money or other property) to the partnership, and (2) such partner's invested capital is a qualified capital interest (which generally requires that (a) the partnership allocations to the invested capital be in a same manner as allocations to other capital interests held by partners who do not hold an ISPI and (b) the allocations to these non-ISPI holders are significant), income attributable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable to the invested capital would be treated as capital gain. However, "invested capital" will not include contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership.

Also, any person who performs services for an entity and holds a "disqualified interest" in the entity is subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest. A "disqualified interest" is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). This is an anti-abuse rule designed to prevent the avoidance of the proposal through the use of compensatory arrangements other than partnership interests. Other anti-abuse rules may be necessary.

The proposal is not intended to adversely affect qualification of a real estate investment trust owning a carried interest in a real estate partnership.

The proposal would be effective for taxable years ending after December 31, 2013.

## **ELIMINATE THE DEDUCTION FOR CONTRIBUTIONS OF CONSERVATION EASEMENTS ON GOLF COURSES**

### **Current Law**

A deduction is generally available for charitable contributions of cash and property. This deduction is limited - or disallowed entirely - for certain types of hard-to-value property. In general, no charitable deduction is allowed for a contribution of a partial interest in property. An exception to this rule provides that a donor may deduct the value of a conservation easement (a partial interest) that is donated to a qualified charitable organization exclusively for conservation purposes. The value of the deduction for any contribution that produces a return benefit to the donor must be reduced by the value of the benefit received.

### **Reasons for Change**

Recent court decisions have upheld large deductions taken for contributions of easements preserving recreational amenities, including golf courses, surrounded by upscale, private home sites. These contributions have raised concerns both that the deduction amounts claimed for such easements (often by the developers of the private home sites) are excessive, and also that the conservation easement deduction is not narrowly tailored to promote only bona fide conservation activities, as opposed to the private interests of donors. These concerns are particularly strong in the case of the deduction for contributions of easements on golf courses. The benefit of an easement on a private golf course, especially one that is part of a luxury housing development, may accrue to a limited number of users such as members of the course club or the owners of the surrounding homes, not the general public, and the construction and operation of the course may even result in environmental degradation. Easements on golf courses are particularly susceptible to overvaluation, as private interests often profit from the contribution of the easement. Because of the difficulty determining both the value of the easement and the value of the return benefits provided to the donor – including indirect benefits, such as the increase in the value of home sites surrounding the golf course – it is difficult and costly for the Internal Revenue Service to challenge inflated golf course easement deductions. Thus, to promote the kinds of public benefits intended by the charitable deduction provision and to prevent abuses, no charitable deduction should be allowed for contributions of easements on golf courses.

### **Proposal**

The proposal would amend the charitable contribution deduction provision to prohibit a deduction for any contribution of a partial interest in property that is, or is intended to be, used as a golf course.

The proposal would be effective as of the date of enactment.

## **RESTRICT DEDUCTIONS AND HARMONIZE THE RULES FOR CONTRIBUTIONS OF CONSERVATION EASEMENTS FOR HISTORIC PRESERVATION**

### **Current Law**

A deduction is generally available for charitable contributions of cash and property. The value of the deduction for any contribution resulting in a return benefit to the donor is reduced by the value of the benefit received. The charitable deduction is limited - or disallowed entirely - for certain types of hard-to-value property. In general, no charitable deduction is allowed for a contribution of a partial interest in property. An exception to this rule allows a donor to deduct the value of a conservation easement (a partial interest) that is donated to a qualified charitable organization exclusively for conservation purposes, including for the preservation of certain certified historic structures. To qualify as a certified historic structure, a building must either be located in a registered historic district or be listed in the National Register of Historic Places. A 2006 amendment to the Internal Revenue Code added several special rules, including additional substantiation rules, for contributions of easements protecting the exterior of buildings located in registered historic districts. These rules do not apply to buildings listed in the National Register.

### **Reasons for Change**

Concerns have been raised that the deduction amounts claimed for historic preservation easements are excessive and may not appropriately take into account existing limitations on the property. Because it can be difficult to determine the fair market value of such easements directly, the value of the deduction is generally determined by assessing the drop in the value of the property caused by the imposition of the easement. The value of the easement may be zero if it does not restrict future development more than the restrictions already imposed on the building, for example, by local zoning or historic preservation authorities. Some taxpayers, however, have taken large deductions for contributions of easements restricting the upward development of historic urban buildings even though such development was already restricted by local authorities. Because of the difficulty of determining the value of the contributed easement, it is difficult and costly for the Internal Revenue Service to challenge deductions for historic preservation easements. To prevent abuses, no deduction should be allowed for the value associated with forgone upward development above an historic building.

In addition, to maintain consistency, the special rules applicable to buildings in registered historic districts should be extended to apply to buildings listed in the National Register.

### **Proposal**

The proposal would disallow a deduction for any value of an historic preservation easement associated with forgone upward development above an historic building. It would also require contributions of conservation easements on buildings listed in the National Register to comply with the same special rules currently applicable to buildings in a registered historic district.

The proposal would be effective for contributions made after the date of enactment.

## **REQUIRE NON-SPOUSE BENEFICIARIES OF DECEASED INDIVIDUAL RETIREMENT ACCOUNT OR ANNUITY (IRA) OWNERS AND RETIREMENT PLAN PARTICIPANTS TO TAKE INHERITED DISTRIBUTIONS OVER NO MORE THAN FIVE YEARS**

### **Current Law**

Minimum distribution rules apply to employer sponsored tax-favored retirement plans and to individual retirement arrangements. In general, under these rules, distributions must begin no later than the required beginning date and a minimum amount must be distributed each year. For traditional IRAs, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 70½. For employer-sponsored tax-favored retirement plans, the required beginning date for a participant who is not a 5 percent owner is April 1 after the later of the calendar year in which the participant attains age 70½ or retires. Under a defined contribution plan or IRA, the minimum amount required to be distributed is based on the joint life expectancy of the participant or employee and a designated beneficiary (who is generally assumed to be 10 years younger), calculated at the end of each year.

Minimum distribution rules also apply to balances remaining after a plan participant or IRA owner has died. The after-death rules vary depending on (1) whether a participant or IRA owner dies on or after the required beginning date or before the required beginning date, and (2) whether there is an individual designated as a beneficiary under the plan. The rules also vary depending on whether the participant's or IRA owner's spouse is the sole designated beneficiary.

If a plan participant or IRA owner dies on or after the required beginning date and there is a non-spouse individual designated as beneficiary, the distribution period is the beneficiary's life expectancy, calculated in the year after the year of death. The distribution period for later years is determined by subtracting one year from the initial distribution period for each year that elapses. If there is no individual designated as beneficiary, the distribution period is equal to the expected remaining years of the participant's or IRA owner's life, calculated as of the year of death.

If a participant or IRA owner dies before the required beginning date and any portion of the benefit is payable to a non-spouse designated beneficiary, distributions must either begin within one year of the participant's or IRA owner's death and be paid over the life or life expectancy of the designated beneficiary or be paid entirely by the end of the fifth year after the year of death.

If the designated beneficiary dies during the distribution period, distributions continue to any subsequent beneficiaries over the remaining years in the distribution period.

If a participant or IRA owner dies before the required beginning date and there is no individual designated as beneficiary, then the entire remaining interest of the participant or IRA owner must generally be distributed by the end of the fifth year following the individual's death.

The minimum distribution rules do not apply to Roth IRAs during the life of the account owner, but do apply to balances remaining after the death of the owner.

## **Reasons for Change**

The Internal Revenue Code gives tax preferences for retirement savings accounts primarily to provide retirement security for individuals and their spouses. The preferences were not created with the intent of providing tax preferences to the non-spouse heirs of individuals. Because the beneficiary of an inherited account can be much younger than a plan participant or IRA owner, the current rules allowing such a beneficiary to stretch the receipt of distributions over many years permit the beneficiary to enjoy tax-favored accumulation of earnings over long periods of time.

## **Proposal**

Under the proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries.

Eligible beneficiaries include any beneficiary who, as of the date of death, is disabled, a chronically ill individual, an individual who is not more than 10 years younger than the participant or IRA owner, or a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner. However, in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

Any balance remaining after the death of a beneficiary (including an eligible beneficiary excepted from the five-year rule or a spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death.

The proposal is effective for distributions with respect to plan participants or IRA owners who die after December 31, 2013. The requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death would also apply to participants or IRA owners who die before January 1, 2014, but only if the beneficiary dies after December 31, 2013. The proposal would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

## **LIMIT THE TOTAL ACCRUAL OF TAX-FAVORED RETIREMENT BENEFITS**

### **Current Law**

Under current law, the maximum benefit permitted to be paid under a qualified defined benefit plan in 2013 is generally \$205,000 per year and is adjusted for increases in the cost of living. The maximum benefit limit is reduced if distributions begin before age 62 and is increased if distributions begin after age 65. The maximum benefit is also adjusted if it is paid in a form other than a straight life annuity or a qualified joint and survivor annuity.

For a defined contribution plan, current law limits the amount of annual contributions or other additions to the account and applies a separate limit to elective deferrals made by taxpayers to the plan, but does not limit the amount that can be accumulated within the account. For 2013, the annual contribution limit is \$51,000, and the elective deferral limit is \$17,500. Each of these limits is adjusted for increases in the cost of living, and each limit is increased by \$5,500 for taxpayers who are 50 or over. Similarly, current law limits the amount of the annual contribution to an individual retirement account or annuity (IRA), but does not limit the amount that can be accumulated within the IRA. The annual contribution limit for 2013 is \$5,500 (adjusted for changes in the cost of living) with an additional \$1,000 for taxpayers who are 50 or over.

While the limitations on the extent to which a taxpayer can make contributions to an IRA are applied based on aggregating all of the taxpayer's IRAs, the limitations on accruals under defined benefit plans and the limitations on contributions under defined contribution plans are not applied by aggregating all such arrangements. Instead, the aggregation is applied solely for multiple plans sponsored by the same employer or related employers, and for this purpose defined benefit plans are not aggregated with defined contribution plans. (Under a combined limit that was in effect from 1976 to 1996, an individual's projected benefits under defined benefit plans were combined with the individual's cumulative contributions under defined contribution plans maintained by the same employer). Furthermore, there is no aggregation for plans that are sponsored by unrelated employers and no coordination between the contribution limits that apply to IRAs and the limits that apply to plans. However, the Tax Reform Act of 1986 imposed an excise tax on excess distributions (and accumulations remaining at death in excess of approximately \$1 million) from (or accumulated in) all qualified plans in which a taxpayer participated (including both defined contribution and defined benefit plans and both related and unrelated employers) and all of the taxpayer's IRAs. The excise tax was repealed in 1997.

Under current law, the annual limit on elective deferrals for a plan also serves as an overall limit on elective deferrals for a taxpayer who participates in 401(k) plans sponsored by unrelated employers. If a taxpayer's aggregate elective deferrals for a year exceed the limit for the year, the taxpayer must include the excess in income for the year of the excess deferral. A grace period is provided to allow taxpayers the opportunity to remove the excess deferrals. If the taxpayer fails to avail himself of this grace period and leaves the excess deferrals in the 401(k) account, then the excess deferrals and attributable earnings will be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a designated Roth account within a plan).

## **Reasons for Change**

The current law limitations on retirement contributions and benefits for each plan in which a taxpayer may participate do not adequately limit the extent to which a taxpayer can accumulate amounts in a tax-favored arrangement through the use of multiple plans. Such accumulations can be considerably in excess of amounts needed to fund reasonable levels of consumption in retirement and are well beyond the level of accumulation that justifies tax-advantaged treatment of retirement savings accounts. Requiring a taxpayer who, in the aggregate, has accumulated very large amounts within the tax-favored retirement system to discontinue adding to those accumulations would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels, while still providing substantial tax incentives for reasonable levels of retirement saving.

## **Proposal**

A taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of \$205,000 payable in the form of a joint and 100% survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 is approximately \$3.4 million.

The limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at 62, in the form of a 100% joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, where actuarial equivalence is determined by treating the individual as if he or she was still 62; the maximum permitted accumulation would continue to be adjusted for cost of living increases. Plan sponsors of defined benefit plans would report the amount of the accrued benefit and the accrual for the year, payable in the same form.

If a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer's investment return for a year was less than the rate of return built into the actuarial equivalence calculation (so that the updated calculation of the equivalent annuity is less than the maximum annuity for a tax-qualified defined benefit plan), there would be room to make additional contributions. In addition, when the maximum defined benefit level increases as a result of the cost-of-living adjustment, the maximum permitted accumulation will automatically increase as well. This also could allow a resumption of contributions for a



taxpayer who previously was subject to a suspension of contributions by reason of the overall limitation.

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).

The proposal would be effective with respect to contributions and accruals for taxable years beginning on or after January 1, 2014.

## **REDUCE THE TAX GAP AND MAKE REFORMS**

### **Expand Information Reporting**

#### **REQUIRE INFORMATION REPORTING FOR PRIVATE SEPARATE ACCOUNTS OF LIFE INSURANCE COMPANIES**

##### **Current Law**

Earnings from direct investment in securities generally result in taxable income to the holder. In contrast, investments in comparable assets through a separate account of a life insurance company generally give rise to tax-free or tax-deferred income. This favorable tax treatment for investing through a life insurance company is not available if the policyholder has so much control over the investments in the separate account that the policyholder, rather than the insurance company, is treated as the owner of those investments.

##### **Reasons for Change**

In some cases, private separate accounts are being used to avoid tax that would be due if the assets were held directly. Better reporting of investments in private separate accounts will help the Internal Revenue Service (IRS) to ensure that income is properly reported. Moreover, such reporting will enable the IRS to identify more easily which variable insurance contracts qualify as insurance contracts under current law and which contracts should be disregarded under the investor control doctrine.

##### **Proposal**

The proposal would require life insurance companies to report to the IRS, for each contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year and represents at least 10 percent of the value of the account, the policyholder's taxpayer identification number, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that was invested in one or more private separate accounts. For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10 percent of the value of the separate account. Whether a related group of persons owns policies whose cash values represent at least 10 percent of the value of the account would be determined quarterly, based on information reasonably within the issuer's possession.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **REQUIRE A CERTIFIED TAXPAYER IDENTIFICATION NUMBER (TIN) FROM CONTRACTORS AND ALLOW CERTAIN WITHHOLDING**

### **Current Law**

In the course of a trade or business, service recipients (“businesses”) making payments aggregating to \$600 or more in a calendar year to any non-employee service provider (“contractor”) that is not a corporation are required to send an information return to the Internal Revenue Service (IRS) setting forth the amount, as well as name, address, and TIN of the contractor. The information returns, required annually after the end of the year, are made on Form 1099-MISC based on identifying information furnished by the contractor but not verified by the IRS. Copies are provided both to the contractor and to the IRS. Withholding is not required or permitted for payments to contractors. Since contractors are not subject to withholding, they may be required to make quarterly payments of estimated income taxes and self-employment (SECA) taxes near the end of each calendar quarter. The contractor is required to pay any balance due when the annual income tax return is subsequently filed.

### **Reasons for Change**

Without accurate taxpayer identifying information, information reporting requirements impose avoidable burdens on businesses and the IRS, and cannot reach their potential to improve compliance.

Estimated tax filing is relatively burdensome, especially for less sophisticated and lower-income taxpayers. Moreover, by the time estimated tax payments (or final tax payments) are due, some contractors will not have put aside the necessary funds. Given that the SECA tax rate is 15.3 percent (up to certain income limits), the required estimated tax payments can be more than 25 percent of a contractor’s gross receipts, even for a contractor with modest income.

An optional withholding method for contractors would reduce the burdens of having to make quarterly payments, would help contractors automatically set aside funds for tax payments, and would help increase compliance.

### **Proposal**

The proposal would require a contractor receiving payments of \$600 or more in a calendar year from a particular business to furnish to the business (on Form W-9) the contractor’s certified TIN. A business would be required to verify the contractor’s TIN with the IRS, which would be authorized to disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records. If a contractor failed to furnish an accurate certified TIN, the business would be required to withhold a flat-rate percentage of gross payments. Contractors receiving payments of \$600 or more in a calendar year from a particular business could require the business to withhold a flat-rate percentage of their gross payments, with the flat-rate percentage of 15, 25, 30, or 35 percent being selected by the contractor.

The proposal would be effective for payments made to contractors after December 31, 2013.

## **MODIFY REPORTING OF TUITION EXPENSES AND SCHOLARSHIPS ON FORM 1098-T**

### **Current Law**

Form 1098-T is used to verify education spending for education-related tax benefits. Eligible institutions of higher learning are required to file each year an information return (Form 1098-T) for each enrolled student for whom a reportable transaction is made. An eligible educational institution is a college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 as in effect on August 5, 1997, and that is eligible to participate in the Department of Education's student aid programs. This includes most accredited public, nonprofit, and private postsecondary institutions.

When filing the Form 1098-T, institutions have the choice of reporting payments received for qualified tuition and related expenses (Box 1) or amounts billed for qualified tuition and related expenses (Box 2) in a given tax year. The eligible educational institution must use the same reporting method for all calendar years unless the Internal Revenue Service (IRS) grants permission to change the reporting method. Qualified tuition and related expenses are tuition, fees, and course materials required for a student to be enrolled at or attend an eligible educational institution.

Institutions of higher education are also required to report scholarships and grants (Box 5) that they administer or distribute (for instance Pell grants). Other entities that provide scholarships and grants are not required to file Form 1098-T to report these amounts to students or to the IRS. Scholarships and grants that are used to pay for tuition and fees, books, supplies, and equipment are not taxable if the student is a degree candidate. Other uses of scholarships and grants, including room and board and travel, are taxable for degree candidates. (Scholarship and grants are taxable for all uses for non-degree students.) Only education spending net of scholarships and grants qualifies for education tax credits.

### **Reasons for Change**

Currently, Form 1098-T may not provide all the information that taxpayers need to claim an education tax credit or to properly report taxable scholarship income. Among institutions that file Form 1098-T, many report amounts billed. However only amounts paid in a given tax year qualify for a tax credit in that tax year. (Amounts billed will not qualify for the credits if the amount was paid in a different tax year.) Scholarships that are paid directly to students rather than administered by schools are not reported on Form 1098-T to students or to the IRS.

Requiring institutions of higher learning to report amounts paid and requiring reporting of all scholarships will assist taxpayers in preparing their returns and allow IRS to monitor and improve compliance.

## **Proposal**

The proposal would require institutions of higher learning to report amounts paid and not amounts billed on the Form 1098-T.

The proposal would also require any entity issuing a scholarship or grant in excess of \$500 that is not processed or administered by an institution of higher learning to report the scholarship or grant on Form 1098-T. The threshold amount is indexed for inflation after 2014. Institutions of higher learning would continue to report the scholarship and grants that they process or administer.

The proposal would be effective for tax years beginning after December 31, 2013.

## **Improve Compliance by Businesses**

### **REQUIRE GREATER ELECTRONIC FILING OF RETURNS**

#### **Current Law**

Corporations with assets of \$10 million or more filing Form 1120 are required to file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More). This Schedule M-3 filing requirement also applies to S corporations, life insurance corporations, property and casualty insurance corporations, and cooperative associations filing various versions of Form 1120 and having \$10 million or more in assets. Schedule M-3 is also required for partnerships with assets of \$10 million or more and certain other partnerships.

Corporations and tax-exempt organizations that have assets of \$10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, are required to file electronically their Form 1120/1120S income tax returns and Form 990 information returns. In addition, private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer. Although electronic filing is required of certain corporations and other taxpayers, others may convert voluntarily to electronic filing.

Generally, regulations may require electronic filing by taxpayers (other than individuals, estates and trusts) that file at least 250 returns annually. Before requiring electronic filing, the Internal Revenue Service (IRS) and Treasury Department must take into account the ability of taxpayers to comply at a reasonable cost.

#### **Reasons for Change**

Typically, compliance increases when taxpayers are required to provide better information to the IRS in usable form. Large organizations with assets of \$10 million or more generally maintain financial records in electronic form, and generally either hire tax professionals who use tax preparation software or use tax preparation software themselves, although they may not currently file electronically.

Electronic filing supports the broader goals of improving IRS service to taxpayers, enhancing compliance, and modernizing tax administration. Overall, increased electronic filing of returns may improve customer satisfaction and confidence in the filing process, and may be more cost effective for affected entities. Expanding electronic filing to certain additional large entities will help provide tax return information in a more uniform electronic form. This will enhance the ability of the IRS to more productively focus its audit activities. This can reduce burdens on businesses where the need for an audit can be avoided.

In the case of a large business, adopting the same standard for electronic filing as for filing Schedule M-3 provides simplification benefits.

### **Proposal**

The proposal would require all those corporations and partnerships that must file Schedule M-3 to file their tax returns electronically. In the case of certain other large taxpayers that are not required to file Schedule M-3 (such as exempt organizations), the regulatory authority to require electronic filing would be expanded to allow reduction of the current threshold of filing 250 or more returns during a calendar year. Additionally, the regulatory authority would be expanded to allow reduction of the 250-return threshold in the case of information returns such as those required by Subpart B, Part III, Subchapter A, Chapter 61, Subtitle F, of the Internal Revenue Code (generally Forms 1099, 1098, 1096, and 5498). Nevertheless, any new regulations would balance the benefits of electronic filing against any burden that might be imposed on taxpayers, and implementation would take place incrementally to afford adequate time for transition to electronic filing. Taxpayers would be able to request waivers of this requirement if they cannot meet the requirement due to technological constraints, if compliance with the requirement would result in undue financial burden, or if other criteria specified in regulations are met.

The proposal would be effective for taxable years ending after December 31, 2013.

## **MAKE E-FILING MANDATORY FOR EXEMPT ORGANIZATIONS**

### **Current Law**

Current law requires that a tax-exempt organization must file its Form 990 series return (Form 990, 990-PF, or 990-EZ) electronically only if it files at least 250 returns during the calendar year. Organizations that are excused from filing Form 990 or Form 990-EZ, generally because their gross receipts are normally less than \$50,000 annually, must file an annual notice (Form 990-N) in electronic format. Churches and governmental entities, as well as certain related organizations, generally do not have to file annual returns or notices. However, all tax-exempt organizations, including churches, must report unrelated business taxable income on Form 990-T, which currently cannot be e-filed. Treasury has limited authority to prescribe which returns must be filed electronically, and the result is that currently only very small and very large organizations are required to file electronically.

### **Reasons for Change**

Because the current rules only require very small and very large organizations to file electronically, only a minority of tax-exempt organizations e-file. Expanding e-filing of Form 990 series returns would help promote a stronger tax-exempt sector by improving the quality of the data used by the Internal Revenue Service (IRS) for tax administration and the timeliness of the public disclosure of the return data.

Electronic filing results in more accurate and complete data being provided to the IRS. E-filing also results in more useable data becoming publicly available more quickly than paper-filed Form 990 series returns, which must first be converted to machine readable format. Once publicly available, the Form 990 series return data may be used by donors to make more informed contribution decisions and by researchers, analysts, and entrepreneurs to understand the tax-exempt sector better and to create information tools and services to meet the needs of the sector. The Form 990 series return data would also be useful to state and local regulators, charity watch-dog groups, charitable beneficiaries, and the press. In addition, e-filing would allow the IRS to process returns at a lower cost than when paper returns are filed.

### **Proposal**

The proposal would require all tax-exempt organizations that must file Form 990 series returns to file them electronically. The proposal would also require the IRS to make the electronically filed Form 990 series returns publicly available in a machine readable format in a timely manner, as provided in regulations.

The proposal would generally be effective for taxable years beginning after the date of enactment. Transition relief would allow up to three additional years to begin electronic filing for smaller organizations and organizations for which electronic filing would be an undue hardship without additional transition time. In addition, the proposal would give the IRS discretion to delay the effective date for Form 990-T filers for up to three taxable years.



## **AUTHORIZE THE DEPARTMENT OF THE TREASURY TO REQUIRE ADDITIONAL INFORMATION TO BE INCLUDED IN ELECTRONICALLY FILED FORM 5500 ANNUAL REPORTS AND ELECTRONIC FILING OF CERTAIN OTHER EMPLOYEE BENEFIT PLAN REPORTS**

### **Current Law**

Section 6058 of the Internal Revenue Code (Code) requires the employer or employers maintaining a funded plan of deferred compensation (or the administrator of the plan) to file an annual return containing certain information in accordance with regulations prescribed by the Secretary of the Treasury. Section 6059 requires that the administrator of a pension plan subject to the minimum funding requirements of section 412 file an actuarial report prepared by an enrolled actuary. Similarly, Title I of the Employee Retirement Income Security Act of 1974 (ERISA) requires that certain pension and welfare benefit plans file an annual report disclosing certain information to the Department of Labor (DOL). These Code and ERISA filing requirements have been consolidated into a single series of forms (Form 5500 and attachments) that is filed with the DOL and then shared with the Internal Revenue Service (IRS). This filing serves as the primary tool for gathering information and for appropriate targeting of enforcement activity regarding such plans. It also serves to satisfy certain requirements for filing with the Pension Benefit Guaranty Corporation.

Section 6057 requires the administrator of a plan that is subject to the vesting standards of ERISA to file, within the time prescribed by regulations, a registration statement with the Secretary of the Treasury, and to provide the registration statement to affected participants. The registration statement must set forth certain information relating to the plan, including a list of plan participants who separate from service covered by the plan and are entitled to deferred vested retirement benefits, and the nature, amount, and form of deferred vested retirement benefits to which the plan participants are entitled. The registration statement is provided to the Social Security Administration (SSA), and the SSA uses the information in the registration statement to notify participants of potential plan benefits when they begin receiving social security benefits. Historically, the registration statement has been a schedule to Form 5500, however, it is now filed with the IRS as a stand-alone Form 8955-SSA.

### **Reasons for Change**

The Department of Labor has the authority to require electronic filing of information relevant to Title I of ERISA and has exercised its authority to require that Form 5500 and its attachments be filed electronically. However, under section 6011(e), the Treasury and IRS lack general statutory authority to require electronic filing of returns unless the person subject to the filing requirement must file at least 250 returns during the year. As a result, information relevant only to tax Code requirements (such as data on coverage needed to test compliance with nondiscrimination rules) and not to DOL's ERISA Title I jurisdiction cannot be requested on the electronically-filed joint Form 5500 and currently is not collected. Collecting it would require a separate "IRS only" form that could be filed on paper, a process that would be neither simple nor efficient for taxpayers or for the IRS and DOL.

This same 250-filings threshold for mandatory electronic filing applies to Form 8955-SSA.

**Proposal**

The proposal would provide the IRS the authority to require in the electronically filed annual reports the inclusion of information that is relevant only to employee benefit plan tax requirements, giving the IRS authority with respect to such tax information comparable to the authority that DOL already has with respect to information relevant to ERISA Title I. The proposal would also provide the IRS with the authority to require electronic filing of Form 8955-SSA

The proposal would be effective for plan years beginning after December 31, 2013.

## **IMPLEMENT STANDARDS CLARIFYING WHEN EMPLOYEE LEASING COMPANIES CAN BE HELD LIABLE FOR THEIR CLIENTS' FEDERAL EMPLOYMENT TAXES**

### **Current Law**

Employers are required to withhold and pay Federal Insurance Contribution Act taxes and to withhold and remit income taxes, and are required to pay Federal Unemployment Tax Act taxes (collectively “Federal employment taxes”) with respect to wages paid to their employees. Liability for Federal employment taxes generally lies with the taxpayer that is determined to be the employer under a multi-factor common law test or under specific statutory provisions. For example, a third party that is not the common law employer can be a statutory employer if the third party has control over the payment of wages. In addition, certain designated agents are jointly and severally liable with their principals for employment taxes with respect to wages paid to the principals’ employees. These designated agents prepare and file employment tax returns using their own name and employer identification number. In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients’ returns. Reporting agents prepare and file employment tax returns for their clients using the client’s name and employer identification number.

Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer’s employees. Employee leasing companies (often referred to as professional employer organizations) typically prepare and file employment tax returns for their clients using the leasing company’s name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of their clients’ workers.

### **Reasons for Change**

Under present law, there is often uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client’s workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to wages paid by a taxpayer that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

Providing standards for when an employee leasing company and its clients will be held liable for Federal employment taxes will facilitate the assessment, payment, and collection of those taxes and will preclude taxpayers who have control over withholding and payment of those taxes from denying liability when the taxes are not paid.

### **Proposal**

The proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also

provide standards for holding employee leasing companies solely liable for such taxes if they meet specified requirements.

The provision would be effective for employment tax returns required to be filed with respect to wages paid after December 31, 2013.

## **INCREASE CERTAINTY WITH RESPECT TO WORKER CLASSIFICATION**

### **Current Law**

For both tax and nontax purposes, workers must be classified into one of two mutually exclusive categories: employees or self-employed (sometimes referred to as independent contractors).

Worker classification generally is based on a common-law test for determining whether an employment relationship exists. The main determinant is whether the service recipient (employer) has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result. For classification purposes, it does not matter whether the service recipient exercises that control, only that he or she has the right to exercise it. Even though it is generally recognized that more highly skilled workers may not require much guidance or direction from the service recipient, the underlying concept of the right to control is the same for them. In determining worker status, the Internal Revenue Service (IRS) looks to three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test: behavioral control, financial control, and the relationship of the parties.

For employees, employers are required to withhold income and Federal Insurance Contribution Act (FICA) taxes and to pay the employer's share of FICA taxes. Employers are also required to pay Federal Unemployment Tax Act (FUTA) taxes and generally state unemployment compensation taxes. Liability for Federal employment taxes and the obligation to report the wages generally lie with the employer.

For workers who are classified as independent contractors, service recipients engaged in a trade or business and making payments totaling \$600 or more in a calendar year to an independent contractor that is not a corporation are required to send an information return to the IRS and to the independent contractor stating the total payments made during the year. The service recipient generally does not need to withhold taxes from the payments reported unless the independent contractor has not provided its taxpayer identification number to the service recipient. Independent contractors pay Self-Employment Contributions Act (SECA) tax on their net earnings from self-employment (which generally is equivalent to both the employer and employee shares of FICA tax). Independent contractors generally are required to pay their income tax, including SECA liabilities, by making quarterly estimated tax payments.

For workers, whether employee or independent contractor status is more beneficial depends on many factors including the extent to which an independent contractor is able to negotiate for gross payments that include the value of nonwage costs that the service provider would have to incur in the case of an employee. In some circumstances, independent contractor status is more beneficial; in other circumstances, employee status is more advantageous.

Under a special provision (section 530 of the Revenue Act of 1978 which was not made part of the Internal Revenue Code), a service recipient may treat a worker as an independent contractor for Federal employment tax purposes even though the worker actually may be an employee under the common law rules if the service recipient has a reasonable basis for treating the worker

as an independent contractor and certain other requirements are met. The special provision applies only if (1) the service recipient has not treated the worker (or any worker in a substantially similar position) as an employee for any period beginning after 1977, and (2) the service recipient has filed all Federal tax returns, including all required information returns, on a basis consistent with treating the worker as an independent contractor.

If an employer meets the requirements for the special provision with respect to a class of workers, the IRS is prohibited from reclassifying the workers as employees, even prospectively and even as to newly hired workers in the same class. Since 1996, the IRS has considered the availability of the special provision as the first part of any examination concerning worker classification. If the IRS determines that the special provision applies to a class of workers, it does not determine whether the workers are in fact employees or independent contractors. Thus, the worker classification continues indefinitely even if it is incorrect.

The special provision also prohibits the IRS from issuing generally applicable guidance addressing the proper classification of workers. Current law and procedures also provide for reduced penalties for misclassification where the special provision is not available but where, among other things, the employer agrees to prospective reclassification of the workers as employees.

### **Reasons for Change**

Since 1978, the IRS has not been permitted to issue general guidance addressing worker classification, and in many instances has been precluded from reclassifying workers – even prospectively – who may have been misclassified. Since 1978, there have been many changes in working relationships between service providers and service recipients. As a result, there has been continued and growing uncertainty about the correct classification of some workers.

Many benefits and worker protections are available only for workers who are classified as employees. Incorrect classification as an independent contractor for tax purposes may spill over to other areas and, for example, lead to a worker not receiving benefits for unemployment (unemployment insurance) or on-the-job injuries (workers' compensation), or not being protected by various on-the-job health and safety requirements.

The incorrect classification of workers also creates opportunities for competitive advantages over service recipients who properly classify their workers. Such misclassification may lower the service recipient's total cost of labor by avoiding workers' compensation and unemployment compensation premiums, and could also provide increased opportunities for noncompliance by service providers.

Workers, service recipients, and tax administrators would benefit from reducing uncertainty about worker classification, eliminating potential competitive advantages and incentives to misclassify workers associated with worker misclassification by competitors, and reducing opportunities for noncompliance by workers classified as self-employed, while maintaining the benefits and worker protections associated with an administrative and social policy system that is based on employee status.

## **Proposal**

The proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law. The reduced penalties for misclassification provided under current law would be retained, except that lower penalties would apply only if the service recipient voluntarily reclassifies its workers before being contacted by the IRS or another enforcement agency and if the service recipient had filed all required information returns (Forms 1099) reporting the payments to the independent contractors. For service recipients with only a small number of employees and a small number of misclassified workers, even reduced penalties would be waived if the service recipient (1) had consistently filed Forms 1099 reporting all payments to all misclassified workers and (2) agreed to prospective reclassification of misclassified workers. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases the proper classification of workers may not have been clear. (Statutory employee or nonemployee treatment as specified under current law would be retained.)

The Department of the Treasury and the IRS also would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards. This would enable service recipients to properly classify workers with much less concern about future IRS examinations. Treasury and the IRS would be directed to issue guidance interpreting common law in a neutral manner recognizing that many workers are, in fact, not employees. Further, Treasury and the IRS would develop guidance that would provide safe harbors and/or rebuttable presumptions, both narrowly defined. To make that guidance clearer and more useful for service recipients, it would generally be industry- or job-specific. Priority for the development of guidance would be given to industries and jobs in which application of the common law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been failures to report compensation paid.

Service recipients would be required to give notice to independent contractors, when they first begin performing services for the service recipient, that explains how they will be classified and the consequences thereof, e.g., tax implications, workers' compensation implications, wage and hour implications.

The IRS would be permitted to disclose to the Department of Labor information about service recipients whose workers are reclassified.

To ease compliance burdens for independent contractors, independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold for Federal tax purposes a flat rate percentage of their gross payments, with the flat rate percentage being selected by the contractor.

The proposal would be effective upon enactment, but prospective reclassification of those covered by the current special provision would not be effective until the first calendar year beginning at least one year after date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status.

## **REPEAL SPECIAL ESTIMATED TAX PAYMENT PROVISION FOR CERTAIN INSURANCE COMPANIES**

### **Current Law**

An insurance company uses reserve accounting to compute losses incurred. That is, losses incurred for the taxable year includes losses paid during the taxable year (net of salvage and reinsurance recovered), plus or minus the increase or decrease in discounted unpaid losses during the year. An adjustment is also made for the change in discounted estimated salvage and reinsurance recoverable.

Unpaid losses are determined on a discounted basis to account for the time that may elapse between an insured loss event and the payment or other resolution of the claim. Taxpayers may, however, elect under section 847 to take an additional deduction equal to the difference between the amount of their reserves computed on a discounted basis and the amount computed on an undiscounted basis. In order to do so, a taxpayer must make a special estimated tax payment (SETP) equal to the tax benefit attributable to the additional deduction. In addition, the additional deductions are added to a special loss discount account. In future years, as losses are paid, amounts are subtracted from the special discount account and included in gross income; the SETPs are used to offset tax generated by these income inclusions. To the extent an amount added to the special loss discount account is not subtracted within 15 years, it is automatically subtracted (and included in gross income) for the 15th year. This regime of additional deductions and SETPs is, by design, revenue neutral.

### **Reasons for Change**

Although this provision is revenue neutral, it imposes a substantial recordkeeping burden on both taxpayers and the Internal Revenue Service. Records must be maintained for up to 15 years for both amounts added to the special loss discount account and amounts paid as SETPs. Additional complexities frequently arise, such as when a taxpayer has a net operating loss carryback, or when a taxpayer is subject to regular tax in one year and alternative minimum tax in another. Also, further complexity arises under section 847 because an insurance company must account for tax benefits that would arise from the filing of a consolidated return with other insurance companies without taking into account statutory limitations on the absorption of losses of non-life insurers against income of life insurance companies.

### **Proposal**

The proposal would repeal section 847 of the Internal Revenue Code, effective for taxable years beginning after December 31, 2013.

The entire balance of any existing special loss discount account would be included in gross income for the first taxable year beginning after December 31, 2013, and the entire amount of existing SETPs would be applied against additional tax that is due as a result of that inclusion. Any SETPs in excess of the additional tax that is due would be treated as an estimated tax payment under section 6655.



In lieu of immediate inclusion in gross income for the first taxable year beginning after December 31, 2013, taxpayers would be permitted to elect to include the balance of any existing special loss discount account in gross income ratably over a four taxable year period, beginning with the first taxable year beginning after December 31, 2013. During this period, taxpayers would be permitted to use existing SETPs to offset any additional tax that is due as a result of that inclusion. At the end of the fourth year, any remaining SETPs would be treated as an estimated tax payment under section 6655.

## **Strengthen Tax Administration**

### **IMPOSE LIABILITY ON SHAREHOLDERS PARTICIPATING IN “INTERMEDIARY TRANSACTION TAX SHELTERS” TO COLLECT UNPAID CORPORATE INCOME TAXES**

#### **Current Law**

The Internal Revenue Service (IRS) and Treasury Department have identified “Intermediary Transaction Tax Shelters” as listed transactions that require disclosure on a tax return to avoid certain penalties. These transactions typically involve (1) a sale of a controlling interest (at least 50 percent) in the stock of a C corporation (2) that is undertaken as part of a plan (3) to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation’s stock. These transactions are structured so that when a C corporation’s assets are sold, the C corporation is ultimately left with insufficient assets from which to pay the tax owed from the asset sale.

In a typical case, an intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation’s shareholders. Since the transaction is designed to avoid corporate level income taxes, the sales price is inflated to reflect the unpaid corporate income tax liability. The consideration received by the C corporation from the sale of its assets is effectively used to repay loans incurred to finance the purchase of the C corporation’s stock. No assets are left inside the C corporation to pay the C corporation’s income tax liability.

Outside of the consolidated return context, former shareholders of a C corporation generally are not liable for any unpaid income taxes, interest, additions to tax, or penalties owed by the C corporation.

#### **Reasons for Change**

Despite such transactions being identified by the IRS as listed transactions since 2001, shareholders, corporate officers and directors, and their advisors have continued to engage in Intermediary Transaction Tax Shelters due to the Federal government’s inability to effectively collect the unpaid income taxes, interest, additions to tax, or penalties owed by a C corporation that has insufficient assets. Thus, existing law does not adequately protect the Federal government’s interest in collecting the amounts due as a result of these transactions.

#### **Proposal**

The proposal would add a new section to the Internal Revenue Code (Code) that would impose liability on shareholders who enter into an Intermediary Transaction Tax Shelter. The proposal applies to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50 percent) in the stock of a C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the C corporation stock. The liability would arise only after the C corporation was assessed income taxes, interest, additions to tax, and penalties with

respect to any taxable year within the 12-month period before or after the date that its stock was disposed of and the C corporation did not pay such amounts within 180 days after assessment.

The amount of a shareholder's liability would equal the lesser of the value of the total proceeds received by the shareholder for the disposed of stock or the income tax liability the C corporation would have had if it had liquidated in a fully taxable transaction on the date that at least 50 percent of its stock was sold, decreased by the income tax paid by the C corporation with respect to tax years beginning or ending within 12 months of the date that at least 50 percent of its stock was sold, and increased by any unpaid penalties, additions to tax, and interest owed by the C corporation with respect to any tax year that begins or ends within 12 months of the date that at least 50 percent of its stock was sold.

For the proposal to apply, the sale of the C corporation stock must be part of a plan (or series of related transactions) constituting an Intermediary Transaction Tax Shelter. The proposal would grant the Treasury Department authority to define an Intermediary Transaction Tax Shelter in regulations.

The proposal would not apply with respect to dispositions of a controlling interest (1) in the stock of a corporation or real estate investment trust with shares traded on an established securities market in the United States, (2) in the shares of a regulated investment company that offers shares to the public, or (3) to an acquirer whose stock or securities are publicly traded on an established market in the United States, or is consolidated for financial reporting purposes with such a public issuer of stock or securities.

The proposal would close the taxable year of any C corporation whose stock was disposed of in an Intermediary Transaction Tax Shelter as of the later of a disposition of a controlling interest in its stock or a disposition of all of its assets. The proposal would also amend the Code to provide that the amount that the selling shareholder was liable for under this proposal would constitute a deficiency that was governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment.

The proposal would be effective upon enactment.

## **INCREASE LEVY AUTHORITY FOR PAYMENTS TO MEDICARE PROVIDERS WITH DELINQUENT TAX DEBT**

### **Current Law**

Under the Medicare Improvement for Patients and Providers Act of 2008, the Treasury Department is authorized to continuously levy up to 15 percent of a payment to a Medicare provider in order to collect delinquent tax debt. Through the Federal Payment Levy Program, Treasury deducts (levies) a portion of a Government payment to an individual or business in order to collect unpaid taxes.

### **Reasons for Change**

Certain Medicare providers fail to comply with their Federal income tax and/or employment tax obligations. Expanding to 100 percent the amount of Federal payments that can be levied for such providers will help recover a greater amount of delinquent taxes and will promote these providers' compliance with their Federal tax obligations.

### **Proposal**

The proposal would allow Treasury to levy up to 100 percent of a payment to a Medicare provider to collect unpaid taxes.

The proposal would be effective for payments made after the date of enactment.

## **IMPLEMENT A PROGRAM INTEGRITY STATUTORY CAP ADJUSTMENT FOR TAX ADMINISTRATION**

### **Current Law**

Previous Administrations and Congresses have used a budget mechanism called a program integrity cap adjustment to increase congressional allocations for annual budget appropriations. Under the mechanism, funding above the spending ceiling that is specified in the annual congressional appropriations process is granted for specified “program integrity” purposes. “Program integrity” broadly refers to maintaining the effectiveness of a specific government program. In the past, Congress has appropriated additional funding to the Internal Revenue Service (IRS) through allocation adjustments for certain enforcement and compliance activities that generate positive net revenue.

### **Reasons for Change**

The IRS currently collects about \$55 billion in enforcement revenue each year through various enforcement and compliance activities, funded partially through a cap adjustment. These resources have been critical to maintaining the IRS enforcement and compliance functions, allowing the IRS to initiate new programs that generate high returns on investment, and encouraging taxpayers to comply with the tax laws. Additional funding for IRS enforcement and compliance programs will yield increases in enforcement revenue through activities with high returns and will help the IRS further expand and improve its effectiveness and efficiency as a tax administrator.

### **Proposal**

The Administration proposes an adjustment to the discretionary spending limits for IRS tax enforcement, compliance, and related activities, including tax administration activities at the Alcohol and Tobacco Tax and Trade Bureau, through an amendment to the Balanced Budget and Emergency Deficit Control Act of 1985, as amended by the Budget Control Act of 2011. The proposed cap adjustment for fiscal year 2014 will fund over \$400 million in new revenue-producing initiatives above current levels of enforcement and compliance activity. These resources will help the IRS continue to target international tax compliance, identify and prevent refund fraud, and restore previously reduced enforcement levels. Beyond 2014, the Administration proposes further increases in additional new revenue-generating initiatives each fiscal year from 2015 through 2018 and to fund all of the new initiatives and inflationary costs via cap adjustments through FY 2023. The total cost of supporting new initiatives above the funding needed to maintain current levels of enforcement and compliance activity would be approximately \$14 billion over the budget window.

## **STREAMLINE AUDIT AND ADJUSTMENT PROCEDURES FOR LARGE PARTNERSHIPS**

### **Current Law**

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established unified audit rules applicable to all but certain small partnerships.

These rules require the tax treatment of all “partnership items” to be determined at the partnership, rather than the partner, level. The rules also require a partner to report all partnership items consistently with the partnership return, unless the partner notifies the Internal Revenue Service (IRS) of any inconsistency. The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Nevertheless, the IRS must still assess any resulting adjustment against each of the taxpayers who were partners in the year in which the misstatement of tax liability arose. In addition, any partner can request an administrative adjustment or a refund for his own separate tax liability and participate in partnership-level administrative proceedings. The TEFRA partnership rules also require the IRS to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than 1 percent.

Because “[the TEFRA] audit and adjustment procedures for large partnerships are inefficient and more complex than those for other large entities,”<sup>4</sup> the Taxpayer Relief Act of 1997 established streamlined audit and adjustment procedure, as well as a simplified reporting system, for electing large partnerships (ELPs), which are generally defined as partnerships that have 100 or more partners during the preceding taxable year and elect to be treated as an ELP.

Under the streamlined ELP audit and adjustment procedures, the IRS generally makes adjustments at the partnership level that flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners’ share of current-year partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner’s distributive shares). Unlike the TEFRA partnership rules, only the partnership can request a refund and the partners of an ELP do not have the right to participate in partnership-level administrative proceedings. Under the ELP audit rules, the IRS need not give notice to individual partners of the beginning of an administrative proceeding or of a final adjustment. Instead, a notice of partnership adjustments is generally sent to the partnership, and only the partner designated by the partnership may act on behalf of the partnership. In addition, the ELP regime allows for simplified reporting to the IRS.

---

<sup>4</sup> House Conference Report No. 105-220.

## **Reasons for Change**

The present TEFRA partnership audit and adjustment procedures for large partnerships remain inefficient and more complex than those applicable to other large entities. Although the ELP regime was enacted to mitigate the problem, few large partnerships have elected into the ELP regime. In addition, there has been substantial growth in the number and complexity of large partnerships, magnifying the difficulty of auditing large partnerships under the TEFRA partnership procedures.

## **Proposal**

The proposal would mandate the streamlined ELP audit and adjustment procedures, but not the simplified reporting, for any partnership that has 1,000 or more partners at any time during the taxable year, a “Required Large Partnership” (RLP).

An RLP, like an ELP, would not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership’s activities, or personal service corporations the owner-employees of which perform those services; (2) retired partners who had performed those services; or (3) spouses of partners who had performed those services.

An RLP will continue to be treated as an RLP unless it can demonstrate that the number of partners fell below the 1,000 partner threshold for the 60-month period ending with the last day of its most recently ended taxable year. An RLP, however, may elect to continue to be an RLP. In addition, a partnership that has 100 or more partners at any time during the taxable year may elect to be an RLP. If a partnership makes an election provided for in the prior two sentences, the election cannot be revoked for any year without the consent of the Secretary.

For purposes of determining whether a partnership has 1,000 or more partners, any person that owns an interest directly or indirectly in the partnership through one or more pass-thru partners (as defined in section 6231(a)(9)) is treated as a partner. The proposal would require any partnership, estate, trust, S corporation, nominee, or other similar person (“pass-through person”) that owns a direct interest in another pass-through person (“lower-tier pass-through person”) to provide to the lower-tier pass-through person the information necessary for the lower-tier pass-through person to determine the number of owners that the pass-through person has. A pass-through person and a lower-tier pass-through person may agree that the pass-through person need not provide the above information to the lower-tier pass-through person if the parties determine the information is not necessary to determine that the lower-tier partnership has 1,000 or more partners.

The partnership would be required to certify that it had at least 1,000 partners at some time during the taxable year by filing an RLP return. The treatment provided by the certification would be binding on the partnership, all partners of the partnership, and on the IRS. Thus, if a partnership incorrectly filed an RLP return, the RLP procedures would continue to apply for that taxable year. Conversely, if a partnership incorrectly failed to file an RLP return, the TEFRA partnership audit procedures would continue to apply to the partnership for that taxable year.

The proposal, however, would provide that if a partnership incorrectly failed to file an RLP return, the period of limitations on assessment would not expire before the date that is 3 years after the date that the Secretary determined that an RLP return should have been filed. This would allow the IRS sufficient time to carry out the TEFRA partnership procedures. In addition, the partnership would be treated as an RLP for the partnership's taxable year ending on or after the date the Secretary determines and notifies the partnership that an RLP return should have been filed. For example, if on June 1, 2016, the Secretary determines and notifies a calendar-year partnership that it incorrectly failed to file an RLP return for its 2014 taxable year, the partnership would be treated as an RLP for its taxable year ending December 31, 2016.

If a partnership incorrectly failed to file the proper return, a penalty will be imposed on the partnership equal to the product of \$5,000 multiplied by the number of direct and indirect partners of the partnership. The partnership would be liable for any penalty imposed by this provision. No penalty will be imposed if the partnership establishes that there was reasonable cause for, and the partnership acted in good faith with respect to, incorrectly failing to file the proper return.

The proposal would also make simplifying changes to the existing ELP regime. The proposal would eliminate the requirement that an ELP provide information returns to its partners within 2½ months following the close of its taxable year and, instead, require the information returns be provided by the time required for non-ELP partnerships. Additionally, the definition of an ELP would be amended to provide that the number of persons who were partners in the partnership must equal or exceed 100 at any time during the partnership taxable year, as opposed to in the preceding partnership taxable year.

The proposal would allow the Secretary to promulgate regulations to further define these rules, including rules to ensure that taxpayers do not transfer partnership interests with a principal purpose of utilizing the RLP regime to alter the taxpayers' aggregate tax liability, and rules to address foreign pass-through partners including, where appropriate, treating a foreign pass-through partner that is a partnership as an RLP.

The proposal would apply to a partnership's taxable year ending on or after the date that is two years from the date of enactment.



## **REVISE OFFER-IN-COMPROMISE APPLICATION RULES**

### **Current Law**

Current law provides that the Internal Revenue Service (IRS) may compromise any civil or criminal case arising under the internal revenue laws prior to a reference to the Department of Justice for prosecution or defense. In 2006, a new provision was enacted to require taxpayers to make certain nonrefundable payments with any initial offer-in-compromise of a tax case. The new provision requires taxpayers making a lump-sum offer-in-compromise to include a nonrefundable payment of 20 percent of the lump-sum with the initial offer. In the case of an offer-in-compromise involving periodic payments, the initial offer must be accompanied by a nonrefundable payment of the first installment that would be due if the offer were accepted.

### **Reasons for Change**

Requiring nonrefundable payments with an offer-in-compromise may substantially reduce access to the offer-in-compromise program. The offer-in-compromise program is designed to settle cases in which taxpayers have demonstrated an inability to pay the full amount of a tax liability. The program allows the IRS to collect the portion of a tax liability that the taxpayer has the ability to pay. Reducing access to the offer-in-compromise program makes it more difficult and costly to obtain the collectable portion of existing tax liabilities.

### **Proposal**

The proposal would eliminate the requirements that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer.

The proposal would be effective for offers-in-compromise submitted after the date of enactment.

## **EXPAND INTERNAL REVENUE SERVICE (IRS) ACCESS TO INFORMATION IN THE NATIONAL DIRECTORY OF NEW HIRES FOR TAX ADMINISTRATION PURPOSES**

### **Current Law**

The Office of Child Support Enforcement of the Department of Health and Human Services maintains the National Directory of New Hires (NDNH), which is a database that contains data from Form W-4 for newly-hired employees, quarterly wage data from State workforce and Federal agencies for all employees, and unemployment insurance data from State workforce agencies for all individuals who have applied for or received unemployment benefits. The NDNH was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Under current provisions of the Social Security Act, the IRS may obtain data from the NDNH, but only for the purpose of administering the earned income tax credit (EITC) and verifying employment reported on a tax return.

Generally, the IRS obtains employment and unemployment data less frequently than quarterly, and there are significant internal costs of preparing these data for use. Under various State laws, the IRS may negotiate for access to employment and unemployment data directly from State agencies that maintain these data.

### **Reasons for Change**

Employment data are useful to the IRS in administering a wide range of tax provisions beyond the EITC, including verifying taxpayer claims and identifying levy sources. Currently, the IRS may obtain employment and unemployment data on a state-by-state basis, which is a costly and time-consuming process. NDNH data are timely, uniformly compiled, and electronically accessible. Access to the NDNH would increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing data without reducing the current levels of taxpayer privacy.

### **Proposal**

The proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for non-compliant taxpayers, and identification of levy sources. Data obtained by the IRS from the NDNH would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

The proposal would be effective upon enactment.

## **MAKE REPEATED WILLFUL FAILURE TO FILE A TAX RETURN A FELONY**

### **Current Law**

Current law provides that willful failure to file a tax return is a misdemeanor punishable by a term of imprisonment of not more than one year, a fine of not more than \$25,000 (\$100,000 in the case of a corporation), or both. A taxpayer who fails to file returns for multiple years commits a separate misdemeanor offense for each year.

### **Reasons for Change**

Increased criminal penalties would help to deter multiple willful failures to file tax returns.

### **Proposal**

The proposal would provide that any person who willfully fails to file tax returns in any three years within any five consecutive year period, if the aggregated tax liability for such period is at least \$50,000, would be subject to a new aggravated failure to file criminal penalty. The proposal would classify such failure as a felony and, upon conviction, impose a fine of not more than \$250,000 (\$500,000 in the case of a corporation) or imprisonment for not more than five years, or both.

The proposal would be effective for returns required to be filed after December 31, 2013.

## **FACILITATE TAX COMPLIANCE WITH LOCAL JURISDICTIONS**

### **Current Law**

Although Federal tax returns and return information (FTI) generally are confidential, the Internal Revenue Service (IRS) and Treasury Department may share FTI with States as well as certain local government entities that are treated as States for this purpose. Generally, the purpose of information sharing is to facilitate tax administration. Where sharing of FTI is authorized, reciprocal provisions generally authorize disclosure of information to the IRS by State and local governments. State and local governments that receive FTI must safeguard it according to prescribed protocols that require secure storage, restricted access, reports to IRS, and shredding or other proper disposal. Criminal and civil sanctions apply to unauthorized disclosure or inspection of FTI. Indian Tribal Governments (ITGs) are treated as States by the tax law for several purposes, such as certain charitable contributions, excise tax credits, and local tax deductions, but not for purposes of information sharing.

### **Reasons for Change**

IRS and Treasury compliance activity, especially with respect to alcohol, tobacco, and fuel excise taxes, may necessitate information sharing with ITGs. For example, the IRS may wish to confirm if a fuel supplier's claim to have delivered particular amounts to adjacent jurisdictions is consistent with that reported to the IRS. If not, the IRS in conjunction with the ITG, which would have responsibility for administering taxes imposed by the ITG, can take steps to ensure compliance with both Federal and ITG tax laws. Where the local government is treated as a State for information sharing purposes, IRS, Treasury, and local officials can support each other's efforts. Where the local government is not so treated, there is an impediment to compliance activity.

### **Proposal**

For purposes of information sharing, the proposal would treat as States those ITGs that impose alcohol, tobacco, or fuel excise or income or wage taxes, to the extent necessary for ITG tax administration. An ITG that receives FTI would be required to safeguard it according to prescribed protocols. The criminal and civil sanctions would apply.

The proposal would be effective for disclosures made after enactment.

## **EXTEND STATUTE OF LIMITATIONS WHERE STATE ADJUSTMENT AFFECTS FEDERAL TAX LIABILITY**

### **Current Law**

In general, additional Federal tax liabilities in the form of tax, interest, penalties, and additions to tax must be assessed by the Internal Revenue Service (IRS) within three years after the date a return is filed. If an assessment is not made within the required time period, the additional liabilities generally cannot be assessed or collected at any future time. In general, the statute of limitations with respect to claims for refund expires three years from the time the return was filed or two years from the time the tax was paid, whichever is later. The Code contains exceptions to the general statute of limitations.

State and local authorities employ a variety of statutes of limitations for State and local tax assessments. Pursuant to agreement, the IRS and State and local revenue agencies exchange reports of adjustments made through examination so that corresponding adjustments can be made by each taxing authority. In addition, States provide the IRS with reports of potential discrepancies between State returns and Federal returns.

### **Reasons for Change**

The general statute of limitations serves as a barrier to the effective use by the IRS of State and local tax adjustment reports when the reports are provided by the State or local revenue agency to the IRS with little time remaining for assessments to be made at the Federal level. Under the current statute of limitations framework, taxpayers may seek to extend the State statute of limitations or postpone agreement to State proposed adjustments until such time as the Federal statute of limitations expires in order to preclude assessment at the Federal level. In addition, it is not always the case that a taxpayer that files an amended State or local return reporting additional liabilities at the State or local level that also affect Federal tax liability will file an amended return at the Federal level.

### **Proposal**

The proposal would create an additional exception to the general three-year statute of limitations for assessment of Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations would be extended to the greater of: (1) one year from the date the taxpayer first files an amended tax return with the IRS reflecting adjustments to the State or local tax return; or (2) two years from the date the IRS first receives information from the State or local revenue agency under an information sharing agreement in place between the IRS and a State or local revenue agency. The statute of limitations would be extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment. The statute of limitations would not be further extended if the taxpayer files additional amended returns for the same tax periods as the initial amended return or if the IRS receives additional information from the State or local revenue agency under an information sharing agreement. The statute of limitations on claims for refund would be extended correspondingly so that any overall increase

in tax assessed by the IRS as a result of the State or local examination report would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

The proposal would be effective for returns required to be filed after December 31, 2013.

## **IMPROVE INVESTIGATIVE DISCLOSURE STATUTE**

### **Current Law**

Generally, tax return information is confidential, unless a specific exception in the Internal Revenue Code (Code) applies. In the case of tax administration, the Code permits Treasury and Internal Revenue Service (IRS) officers and employees to disclose return information to the extent necessary to obtain information that is not otherwise reasonably available, in the course of an audit or investigation, as prescribed by regulation. Thus, for example, a revenue agent may identify himself or herself as affiliated with the IRS, and may disclose the nature and subject of an investigation, as necessary to elicit information from a witness in connection with that investigation. Criminal and civil sanctions apply to unauthorized disclosures of return information.

### **Reasons for Change**

Treasury Regulations effective since 2003 state that the term “necessary” in this context does not mean essential or indispensable, but rather appropriate and helpful in obtaining the information sought. In other contexts, a “necessary” disclosure is one without which performance cannot be accomplished reasonably without the disclosure. Determining if an investigative disclosure is “necessary” is inherently factual, leading to inconsistent opinions by the courts. Eliminating this uncertainty from the statute would facilitate investigations by IRS officers and employees, while setting forth clear guidance for taxpayers, thus enhancing compliance with the tax Code.

### **Proposal**

The proposal would clarify the taxpayer privacy law by stating that the law does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

The proposal would be effective for disclosures made after enactment.

## **REQUIRE TAXPAYERS WHO PREPARE THEIR RETURNS ELECTRONICALLY BUT FILE THEIR RETURNS ON PAPER TO PRINT THEIR RETURNS WITH A 2-D BAR CODE**

### **Current Law**

Taxpayers can prepare their tax returns electronically (either by utilizing a tax return preparer or using tax return software at home) and, instead of filing their returns electronically, may print out a paper copy and file the return on paper by mailing it to the Internal Revenue Service (IRS).

### **Reasons for Change**

Electronically filed tax returns are processed more efficiently and more accurately than paper tax returns. When tax returns are filed on paper—even if that paper return was prepared electronically—the IRS is unable to scan the return and the information contained on the return must be manually entered into the IRS's systems.

New scanning technology would allow the IRS to scan paper tax returns and capture all data shown on the return, if the paper return contains a 2-D bar code that would allow conversion of the paper return into an electronic format. This would reduce transcription errors and the amount of training, recruiting, and staffing that the IRS requires to process paper tax returns. In addition, the IRS would have greater access to more accurate tax data, thereby improving case selection, assisting in the detection of fraudulent tax returns, and allowing more comprehensive analysis of taxpayer behavior.

### **Proposal**

The proposal would require all taxpayers who prepare their tax returns electronically but print their returns and file them on paper to print their returns with a 2-D bar code that can be scanned by the IRS to convert the paper return into an electronic format.

The proposal would be effective for tax returns filed after December 31, 2013.



## **ALLOW THE INTERNAL REVENUE SERVICE (IRS) TO ABSORB CREDIT AND DEBIT CARD PROCESSING FEES FOR CERTAIN TAX PAYMENTS**

### **Current Law**

Section 6311 permits the IRS to receive payment of taxes by any commercially acceptable means that the Secretary deems appropriate. Taxpayers may make credit or debit card payments by phone through IRS-designated third-party service providers, but these providers charge the taxpayer a convenience fee over and above the taxes due. Taxpayers cannot make a credit or debit card payment by phone directly to IRS collection representatives. Under current law, if the IRS were to accept credit or debit card payments directly from taxpayers, the IRS is prohibited from absorbing credit or debit card processing fees.

### **Reasons for Change**

When taxpayers agree to make additional payments during telephone consultations with IRS agents, it is inefficient for both taxpayers and the IRS to require taxpayers to contact a third party service provider to make credit and debit card payments. Both the requirement for a separate call to a service provider and the additional processing fee for such payments may also discourage payment of outstanding liabilities, resulting in greater collection costs for the IRS, fewer IRS resources available to contact additional taxpayers, and lower tax collections. Allowing the IRS to accept credit and debit card payments directly and allowing the IRS to absorb the credit and debit card processing fees would increase efficiency and the number of collection cases worked. Permitting the IRS to absorb the processing fee would increase payment options available to taxpayers.

### **Proposal**

The proposal would amend Section 6311(d) to allow, but not require, the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for delinquent tax payments, without charging a separate processing fee to the taxpayer.

The proposal would be effective for payments made after the date of enactment.

## **EXTEND IRS MATH ERROR AUTHORITY IN CERTAIN CIRCUMSTANCES**

### **Current Law**

Section 6213 imposes certain procedural requirements on the Internal Revenue Service (IRS) when it determines that a taxpayer has a deficiency. These general deficiency procedures include referring tax returns that the IRS believes contain errors for an audit of the return. If an examiner determines that there is a deficiency, a statutory notice of deficiency must be issued and the taxpayer is provided an opportunity to challenge the proposed deficiency in Tax Court before the deficiency is assessed. These procedures are time consuming and expend significant IRS resources.

Section 6213(b), however, contains an exception to the general deficiency procedures by granting the IRS authority to correct certain mathematical or clerical errors made on tax returns (such authority is generally referred to as “math error authority”) to reflect the taxpayer’s correct tax liability. “Mathematical and clerical error” is defined in section 6213(g)(2) and currently includes, among other things: (1) errors in addition, subtraction, multiplication, or division shown on any return; (2) an entry on a return of an item that is inconsistent with another entry of the same or another item on the return; (3) an omission of a correct taxpayer identification number (TIN) required to be included on a tax return for the earned income tax credit (EITC); and (4) an omission of a correct TIN required to be included on a return for the higher education tax credits.

### **Reasons for Change**

Using math error authority allows the IRS to adjust tax returns in cases where the IRS has reliable information that a taxpayer has an error on his or her return. Using math error authority in these circumstances is an efficient use of IRS resources.

Current law does not permit the IRS to use math error authority to assess additional amounts if (1) a taxpayer exceeds a lifetime limit on (a) the total amount of a credit or deduction that may be claimed or (b) the total number of years that a credit or deduction may be claimed; or (2) the taxpayer claims the EITC when the taxpayer is banned from doing so for a period of years because it was determined that the taxpayer’s previous EITC claim was due to fraud or reckless or intentional disregard of the rules and regulations.

Adding these two items to the list of circumstances where the IRS is permitted to use math error authority would increase the efficiency of tax administration by permitting the IRS to disallow clearly erroneous claims and reducing the need for audit, and they would promote fairness by limiting such claims to those taxpayers who are, in fact, entitled to them.

## **Proposal**

The proposal would add two items to the list of circumstances where the IRS has math error authority: (1) a taxpayer claimed a deduction or credit in excess of a lifetime limit, or (2) a taxpayer claimed the EITC during a period of disallowance under section 32(k).

The proposal would be effective for taxable years beginning after December 31, 2013.

## **IMPOSE A PENALTY ON FAILURE TO COMPLY WITH ELECTRONIC FILING REQUIREMENTS**

### **Current Law**

Certain corporations and tax-exempt organizations (including certain charitable trusts and private foundations) are required to file their returns electronically. Generally, filing on paper instead of electronically is treated as a failure to file if electronic filing is required. Additions to tax are imposed for the failure to file tax returns that report a liability. For failure to file a corporate return, the addition to tax is 5 percent of the amount required to be shown as tax due on the return for the first month of failure, and an additional 5 percent for each month or part of a month thereafter, up to a maximum of 25 percent.

For failure to file a tax-exempt organization return, the addition to tax is \$20 a day for each day the failure continues. The maximum amount per return is \$10,000 or 5 percent of the organization's gross receipts for the year, whichever is less. Organizations with annual gross receipts exceeding \$1 million, however, are subject to an addition to tax of \$100 per day, with a maximum of \$50,000.

### **Reasons for Change**

Although there are additions to tax for the failure to file returns, there is no specific penalty for a failure to comply with a requirement to file electronically. Because the addition to tax for failure to file a corporate return is based on an underpayment of tax, no addition is imposed if the corporation is in a refund, credit, or loss status. Thus, the existing addition to tax may not provide an adequate incentive for certain corporations to file electronically. Generally, electronic filing increases efficiency of tax administration because the provision of tax return information in an electronic form enables the Internal Revenue Service to focus audit activities where they can have the greatest impact. This also assists taxpayers where the need for audit is reduced.

### **Proposal**

The proposal would establish an assessable penalty for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The amount of the penalty would be \$25,000 for a corporation or \$5,000 for a tax-exempt organization. For failure to file in any format, the existing penalty would remain, and the proposed penalty would not apply.

The proposal would be effective for returns required to be electronically filed after December 31, 2013.

## **RESTRICT ACCESS TO THE DEATH MASTER FILE (DMF)**

### **Current Law**

The DMF is a list of deceased individuals maintained by the Social Security Administration (SSA) that is updated weekly. SSA created the DMF in response to a 1980 consent judgment that requires SSA to provide certain personally identifiable information about deceased individuals under the Freedom of Information Act. The DMF contains the full name, Social Security number (SSN), date of birth, date of death, and the county, state, and zip code of the last address on record for decedents. This information is publicly available and, pursuant to the consent judgment, released weekly by SSA, and many websites publish the information included on the DMF free or for a nominal fee.

Some DMF users need immediate access to the DMF for fraud prevention purposes, such as pension administrators who use DMF data to terminate payments. Others use the information for purposes that are not time-sensitive, such as genealogy research. A third group, however, uses the DMF for illegitimate purposes, including identity thieves who use the DMF to steal the names and SSNs of recent decedents, which information identity thieves then use to file fraudulent tax returns.

### **Reasons for Change**

Refund-fraud related identity theft has grown exponentially in recent years. Fraudulent tax returns using a decedent's identifying information are difficult to detect before improper refunds are paid, because the Internal Revenue Service may not discover that identity theft has occurred until a surviving family member files an income tax return claiming the decedent as a dependent or files the decedent's final income tax return.

Restricting immediate access to those users with a legitimate fraud prevention purpose while delaying the release for other users protects the privacy interests of decedents, reduces opportunities for identity theft, and restricts information sources used to file fraudulent tax returns while still making the information on the DMF available to users who have a legitimate need for the information.

### **Proposal**

The proposal would restrict immediate access to the DMF to those users who legitimately need the information for fraud prevention purposes and to delay the release of the DMF for three years to all other users.

The proposal would be effective upon enactment.

## **PROVIDE WHISTLEBLOWERS WITH PROTECTION FROM RETALIATION**

### **Current Law**

Section 7623 of the Internal Revenue Code (the Code) allows whistleblowers to file claims for an award where the whistleblower submitted information that allowed the Internal Revenue Service (IRS) to detect tax underpayments or detect and bring to trial and punishment persons guilty of violating the internal revenue laws.

Other whistleblower statutes, such as the False Claims Act, explicitly provide whistleblowers with protection from retaliatory actions and whistleblowers who suffer retaliatory action may file a claim in U.S. district court for relief, including reinstatement, back pay, and other damages. There are currently no protections from retaliatory action for whistleblowers who file claims under the Code.

### **Reasons for Change**

The lack of protection from retaliation for whistleblowers who file claims under section 7623 of the Code may discourage whistleblowers from filing claims with the IRS, even though the IRS's general policy is to protect whistleblowers' identities. These safeguards do not fully protect the whistleblower's identity because the IRS may need to identify the whistleblower as a trial witness in the underlying tax case. Moreover, some taxpayers have brought lawsuits against the IRS to discover whether there is a whistleblower who has submitted information about their tax issues and, if so, the whistleblower's identity. Explicitly protecting whistleblowers from retaliatory actions should encourage potential whistleblowers to file claims, which would increase the tax administration benefit of the whistleblower program.

### **Proposal**

The proposal would amend section 7623 to explicitly protect whistleblowers from retaliatory actions, consistent with the protections currently available to whistleblowers under the False Claims Act.

The proposal would be effective upon enactment.

## **PROVIDE STRONGER PROTECTION FROM IMPROPER DISCLOSURE OF TAXPAYER INFORMATION IN WHISTLEBLOWER ACTIONS**

### **Current Law**

Section 6103 provides that tax returns and tax return information are confidential, unless an exception applies. Section 6103(p) imposes safeguarding requirements on certain disclosures of tax return information. In addition, civil and criminal penalties may be imposed on an unauthorized inspection or disclosure of tax return information.

Currently, the Whistleblower Office may share tax return information with whistleblowers and their legal representatives in a whistleblower administrative proceeding under section 6103(h) or by entering into a written agreement with the Internal Revenue Service (IRS) under section 6103(n). Whistleblowers and their representatives who receive tax return information under a section 6103(n) agreement are subject to the section 6103(p) safeguarding requirements, and civil and criminal penalties may apply for unauthorized inspections and disclosures of tax return information. These same protections do not currently extend to information disclosed to whistleblowers in an administrative proceeding under section 6103(h).

### **Reasons for Change**

Most disclosures of tax return information are subject to the section 6103(p) safeguarding requirements, and civil and criminal penalties may apply for unauthorized inspections and disclosures of tax return information. The few exceptions are generally cases where re-disclosure of the tax return information may be beneficial or necessary; for example, the safeguarding requirements do not apply to disclosures made under section 6103(i)(4), which permits the IRS to disclose tax return information to federal officers to administer laws that do not relate to tax administration for use in a judicial or administrative proceeding (i.e., using tax returns as evidence in a non-tax case). There is not a similar policy rationale for exempting whistleblower administrative proceedings from the safeguarding requirements. Furthermore, whistleblowers and their representatives who receive tax return information under section 6103(h) should be subject to the same requirements as whistleblowers and their representatives who receive tax return information under a section 6103(n) agreement because, in both instances, the tax return information is being disclosed to further tax administration and the goals of the whistleblower program.

### **Proposal**

The proposal would amend section 6103 to provide that the section 6103(p) safeguarding requirements apply to whistleblowers and their legal representatives who receive tax return information in whistleblower administrative proceedings. In addition, the proposal extends the penalties for unauthorized inspections and disclosures of tax return information to whistleblowers and their legal representatives. The proposal will not affect a potential whistleblower's ability to file a claim for award or participate in a whistleblower administrative proceeding.

The proposal would be effective upon enactment.



## **INDEX ALL PENALTIES TO INFLATION**

### **Current Law**

The Internal Revenue Code (Code) contains numerous penalty provisions where a fixed penalty amount was established when the penalty was initially added to the Code. These provisions contain no mechanism to adjust the amount of the penalty for inflation, and thus, these penalties are only increased by amending the Code.

### **Reasons for Change**

One of the key goals of an effective tax penalty regime is to encourage compliance, which can be achieved, in part, by setting penalty amounts at a level that serves as a meaningful economic deterrent to non-compliant behavior. Under current practices, however, penalties are only infrequently adjusted for inflation, if they are adjusted at all. Thus, the amount of a penalty often declines for many years in real, inflation adjusted terms, and so becomes too low to continue serving as an effective deterrent. Moreover, increasing penalty amounts through amending the Code is inefficient.

Changing current practice would foster the goal of encouraging compliance, increase the penalty regime's effectiveness in deterring negative behavior, and increase efficiency by eliminating the need to enact legislation to increase individual penalties.

### **Proposal**

The proposal would index all penalties to inflation and round the indexed amount to the next hundred dollars.

The proposal would be effective upon enactment.

## **EXTEND PAID PREPARER EARNED INCOME TAX CREDIT (EITC) DUE DILIGENCE REQUIREMENTS TO THE CHILD TAX CREDIT**

### **Current Law**

Paid preparers who prepare federal income tax returns that involve an EITC must meet certain due diligence requirements. Those who fail to meet the requirements may face a penalty of \$500 for each return for which the requirement was not met. For each tax return, a paid preparer must complete the Paid Preparer's Earned Income Credit Checklist (Form 8867) and the checklist must be filed with the taxpayer's return. The paid preparer is also responsible for fulfilling record-keeping requirements. Prior to 2011, paid preparers were not required to file the checklist with the taxpayer's return and the penalty for noncompliance was \$100.

To meet the due diligence requirements, preparers must complete the checklist based on current and reasonable information. Preparers must also complete the EITC worksheet found in the 1040 instructions (or complete a comparable worksheet of their own creation). Finally, preparers must take steps to ensure that all taxpayer information provided to them is correct and complete by asking follow-up questions to the taxpayer and requesting additional documentation. Preparers must keep a copy of all forms, a record of any additional questions asked and taxpayer's answers, and other information for three years.

The eligibility requirements for the child tax credit, including the definition of a qualifying child, are similar to the eligibility requirements for the EITC. However, paid preparers do not face a similar due diligence requirement for the child tax credit.

### **Reasons for Change**

The Internal Revenue Service (IRS) estimates that the tax gap attributable to individual income tax credits was \$28 billion in 2006 (before enforcement actions). One way to improve voluntary compliance is improve the accuracy of returns submitted by paid preparers. The IRS has a robust program to educate tax return preparers and to identify noncompliant EITC return preparers, who are audited and fined. Extending the due diligence requirement to the child tax credit, which shares many eligibility criteria with the EITC, could improve compliance without excessively increasing the level of burden on paid preparers or taxpayers.

### **Proposal**

The proposal would extend the due diligence requirement to include all federal income tax returns that claim the child tax credit, including the additional child tax credit. The existing checklist would be expanded and adapted to reflect the differences in requirements between the EITC and the child tax credit, while ensuring that the additional burden to preparers and filers is minimized.

The proposal would be effective for tax years beginning after December 31, 2013.

## **EXTEND INTERNAL REVENUE SERVICE (IRS) AUTHORITY TO REQUIRE A TRUNCATED SOCIAL SECURITY NUMBER (SSN) ON FORM W-2**

### **Current Law**

Employers are required to furnish written statements to their employees containing certain information. Employers satisfy this requirement by filing with the IRS Form W-2, Wage and Tax Statement, indicating the SSN, wages paid, taxes withheld, and other information, and providing a copy of the Form W-2 to each employee. Section 6051(a) specifically requires the inclusion of the employee's SSN on the statement.

Other statements provided to taxpayers—such as Forms 1099—are subject to the more general rules under section 6109, which require the filer to include the taxpayer's "identifying number" on the form. Section 6109 provides that, except as otherwise specified in regulations, an individual's SSN is an individual's identifying number for purposes of the Internal Revenue Code. As a result, for some statements, Treasury and the IRS have regulatory authority to require or permit filers to use a number other than the taxpayer's SSN.

### **Reasons for Change**

The incidence of identity theft is increasing, and Treasury and the IRS have taken a multi-pronged approach to combating identity theft. For example, in 2009, the IRS instituted a pilot program permitting filers of certain information returns to truncate a taxpayer's identifying number, including an SSN, on copies of information returns provided to taxpayers. Under the pilot program, the first five digits of a taxpayer's identifying number are replaced with X's or \*'s. The pilot program was implemented in response to concerns about identity theft, particularly the concern that a taxpayer's identifying number could be stolen from a paper payee statement and used to file false or fraudulent returns. The pilot program was favorably received and Treasury and the IRS recently published proposed regulations that would make the pilot program permanent.

Because section 6051 explicitly requires the inclusion of an employee's SSN, Form W-2 could not be included in the pilot program or the proposed regulations. The risk of identity theft from Form W-2 is high because employers are required to file a Form W-2 for each employee who receives wages. Moreover, both the IRS and many state taxing authorities require taxpayers to include a copy of their Form W-2 when filing their annual income tax returns, increasing the risk that a taxpayer's SSN could be stolen. Providing the IRS authority to require or permit truncated SSNs on Forms W-2 would reduce the risk of identity theft and improper payments resulting from false or fraudulent returns.

### **Proposal**

The proposal would revise section 6051 to require employers to include an "identifying number" for each employee, rather than an employee's SSN, on Form W-2. By revising section 6051 to require an identifying number, the general rules under section 6109 would apply and allow

Treasury and the IRS to exercise regulatory authority to require or permit a truncated SSN on Form W-2.

The proposal would be effective upon enactment.

## **ADD TAX CRIMES TO THE AGGRAVATED IDENTITY THEFT STATUTE**

### **Current Law**

The Aggravated Identity Theft Statute permits an increased sentence when the identity of another individual is used to commit certain crimes that are enumerated in the statute. This enumerated list does not include any tax offenses under the Tax Code in Title 26 or tax-related offenses under Title 18, including conspiracy to defraud the government with respect to claims (18 U.S.C. 286), false, fictitious, or fraudulent claims (18 U.S.C. 287), or conspiracy (18 U.S.C. 371). A conviction for aggravated identity theft adds two years to the sentence imposed for the underlying felony.

### **Reasons for Change**

Tax refund-related identity theft, where identity thieves use stolen Social Security numbers to file false or fraudulent tax returns to obtain an improper refund, has increased exponentially in recent years. From 2008 through May 2012, the Internal Revenue Service (IRS) identified over 550,000 taxpayers who were affected by identity theft. Although Treasury and the IRS have implemented a multi-pronged approach to combating identity theft, additional tools are needed. Adding tax offenses to the list of predicate offenses for aggravated identity theft would increase the enforcement tools available to prosecute identity thieves and the potential for an increased prison sentence could serve as an additional deterrent to identity thieves.

### **Proposal**

The proposal would add the tax-related offenses in Title 18 and the criminal tax offenses in Title 26 to the list of predicate offenses contained in the Aggravated Identity Theft Statute. If this proposal is enacted, criminals who are convicted for tax-related identity theft may be subject to longer sentences than the sentences that apply to those criminals under current law.

The proposal would be effective upon enactment.

## **IMPOSE A CIVIL PENALTY ON TAX IDENTITY THEFT CRIMES**

### **Current Law**

Current law does not impose a civil penalty for tax-related identity theft.

### **Reasons for Change**

Tax-related identity theft has increased exponentially in recent years. From 2008 through May 2012, the Internal Revenue Service (IRS) identified over 550,000 taxpayers who were affected by identity theft.

Although the IRS has a variety of tools that it can use to combat identity theft, these tools do not include a civil penalty. While criminal prosecutions can be effective, they are time-consuming and resource-intensive. Civil penalties can serve as an additional deterrent, particularly when used in conjunction with criminal prosecutions. In addition, civil penalties can be imposed more swiftly and efficiently, thereby discouraging identity thieves without imposing significant additional burdens on IRS resources.

### **Proposal**

The proposal would add a \$5,000 civil penalty to the Internal Revenue Code to be imposed in tax identity theft cases on the individual who filed the fraudulent return. Under the proposal, the IRS would be able to immediately assess a separate civil penalty for each incidence of identity theft. There is no maximum penalty amount that may be imposed.

The proposal would be effective upon enactment.

## **SIMPLIFY THE TAX SYSTEM**

### **SIMPLIFY THE RULES FOR CLAIMING THE EARNED INCOME TAX CREDIT (EITC) FOR WORKERS WITHOUT QUALIFYING CHILDREN**

#### **Current Law**

Low and moderate-income workers may be eligible for a refundable EITC. Eligibility for the EITC is based on the number of qualifying children in the worker's household, adjusted gross income (AGI), earned income, investment income, filing status, age, and immigration and work status in the United States.

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a maximum range (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit). The EITC for workers without qualifying children is much smaller and phases out at a lower income level than does the EITC for workers with qualifying children.

In general, taxpayers with low wages who do not have any qualifying children may be eligible to claim the small EITC for workers without qualifying children. However, if the taxpayer resides with a qualifying child whom the taxpayer does not claim (perhaps because that child is claimed by another individual within the household), the taxpayer is not eligible for any EITC.

#### **Reasons for Change**

Prohibiting a taxpayer who resides with a qualifying child whom the taxpayer does not claim from claiming the EITC for workers without qualifying children is confusing to taxpayers and difficult for the Internal Revenue Service to enforce. The prohibition is also inequitable and weakens the work incentives of the credit.

#### **Proposal**

The proposal would allow otherwise eligible taxpayers residing with qualifying children whom they do not claim to claim the EITC for workers without qualifying children.

The proposal would be effective for taxable years beginning after December 31, 2013.

## **MODIFY ADOPTION CREDIT TO ALLOW TRIBAL DETERMINATION OF SPECIAL NEEDS**

### **Current Law**

Taxpayers that adopt children can receive a tax credit for qualified adoption expenses. The amount of the credit is increased in the case of adoption of a special needs child. To be eligible for the increased credit, a State must determine that the child meets the statutory requirements as a “child with special needs.” Under the statute, other governmental entities, such as Indian Tribal Governments (ITGs) do not have the authority to make this determination.

Congress passed the Indian Child Welfare Act (ICWA) in 1978 in response to the high number of Indian children being removed from their homes by public agencies. Among other things, the ICWA allows tribes to manage and maintain adoption programs, in the place of the State, for the children of their tribal members.

### **Reasons for Change**

Like States, many ITGs facilitate adoptions involving special needs. The ICWA programs mirror the programs that are administered by State agencies, and ITGs should be accorded the same deference as State agencies for purposes of the tax credit for adoption expenses.

### **Proposal**

The proposal would amend the tax credit for adoption expenses to allow ITGs to make the status determination of a “child with special needs.”

The proposal would be effective for taxable years beginning after December 31, 2013.



## **ELIMINATE MINIMUM REQUIRED DISTRIBUTION (MRD) RULES FOR INDIVIDUAL RETIREMENT ACCOUNT OR ANNUITY (IRA)/PLAN BALANCES OF \$75,000 OR LESS**

### **Current Law**

The MRD rules generally require participants in tax-favored retirement plans, including qualified plans under section 401(a), section 401(k) cash or deferred arrangements, section 403(a) annuity plans, section 403(b) programs for public schools and charitable organizations, eligible deferred compensation plans under section 457(b), Simplified Employee Pensions (SEPs), and SIMPLE plans, as well as owners of IRAs, to begin receiving distributions shortly after attaining age 70½. The rules also generally require that these retirement assets be distributed to the plan participant or IRA owner (or their spouses or other beneficiaries), in accordance with regulations, over their life or a period based on their life expectancy (or the joint lives or life expectancies of the participant/owner and beneficiary).<sup>5</sup> Roth IRAs are not subject to the MRD rules during the life of the Roth IRA holder, but the MRD rules do apply to Roth IRAs after the death of the holder.

If a participant or account owner fails to take, in part or in full, the minimum required distribution for a year by the applicable deadline, the amount not withdrawn is subject to a 50-percent excise tax.

### **Reasons for Change**

The MRD rules are designed largely to prevent taxpayers from deferring taxation of amounts that were accorded tax-favored treatment to provide financial security during retirement and instead leaving them to accumulate in tax-exempt arrangements for the benefit of their heirs. Therefore, in the case of taxpayers who have accumulated substantial tax-favored retirement assets, the MRD rules help ensure that tax-favored retirement benefits are in fact used for retirement. Under current law, however, millions of senior citizens with only modest tax-favored retirement benefits to fall back on during retirement also must calculate the annual amount of their minimum required distributions, even though they are highly unlikely to try to defer withdrawal and taxation of these benefits for estate planning purposes. In addition to simplifying tax compliance for these individuals, the proposal permits them greater flexibility in determining when and how rapidly to draw down their limited retirement savings.

### **Proposal**

The proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA<sup>6</sup> and tax-favored retirement plan accumulations does not exceed \$75,000 (indexed for inflation) on a measurement date. However, benefits under qualified defined

---

<sup>5</sup> Participants in tax-favored retirement plans (excluding IRAs) other than owners of at least 5 percent of the business sponsoring the retirement plan may wait to begin distributions until the year of retirement, if that year is later than the year in which the participant reaches age 70 ½ .

<sup>6</sup> While Roth IRAs are exempt from the pre-death MRD rules, amounts held in Roth IRAs would be taken into account in determining whether an individual's aggregate retirement accumulations exceed the \$75,000 threshold.

benefit pension plans that have already begun to be paid in life annuity form (including any form of life annuity, such as a joint and survivor annuity, a single life annuity, or a life annuity with a term certain) would be excluded. The MRD requirements would phase in ratably for individuals with aggregate retirement benefits between \$75,000 and \$85,000. The initial measurement date for the dollar threshold would be the beginning of the calendar year in which the individual reaches age 70½ or, if earlier, in which the individual dies, with additional measurement dates only at the beginning of the calendar year immediately following any calendar year in which the individual's IRAs or plans receive contributions, rollovers, or transfers of amounts that were not previously taken into account.

The proposal would be effective for taxpayers attaining age 70½ on or after December 31, 2013 and for taxpayers who die on or after December 31, 2013 before attaining age 70 ½.

## **ALLOW ALL INHERITED PLAN AND INDIVIDUAL RETIREMENT ACCOUNT OR ANNUITY (IRA) BALANCES TO BE ROLLED OVER WITHIN 60 DAYS**

### **Current Law**

Generally, assets can be moved from a tax-favored employer retirement plan or from an IRA into an IRA or into an eligible retirement plan without adverse tax consequences. This movement of assets can generally be accomplished through a direct rollover of a distribution, a 60-day rollover, or a direct trustee-to-trustee transfer that is not a distribution. However, not all of these methods are available with respect to assets of a plan or IRA account inherited by a non-spouse beneficiary.

In particular, when a participant in a tax-favored employer retirement plan dies before all assets in the plan have been distributed, a beneficiary who is a surviving spouse may roll over the assets, by direct rollover or 60-day rollover, into an IRA that is treated either as a spousal inherited IRA or as the surviving spouse's own IRA. A beneficiary who is not a surviving spouse, on the other hand, may roll over the assets into an IRA that is a non-spousal inherited IRA only by means of a direct rollover; a 60-day rollover is not available to a surviving non-spouse beneficiary.

Similarly, when the owner of an IRA dies before all assets in the IRA have been distributed, a surviving spouse beneficiary may elect to treat the assets as his or her own IRA or as a spousal inherited IRA. In addition, a surviving spouse beneficiary may roll over the assets into an IRA that is treated either as the surviving spouse's own IRA or as a spousal inherited IRA. A surviving non-spouse beneficiary, on the other hand, may treat the assets as a non-spousal inherited IRA, and may move the assets to another non-spousal inherited IRA only by means of a direct trustee-to-trustee transfer; rollovers from the deceased owner's IRA to another IRA are not available for a surviving non-spouse beneficiary.

### **Reasons for Change**

The rules that a surviving non-spouse beneficiary under a tax-favored employer retirement plan may roll over assets to an IRA only by means of a direct rollover and that a surviving non-spouse beneficiary under an IRA may move assets to a non-spousal inherited IRA only by means of a direct trustee-to-trustee transfer create traps for the unwary. These differences in rollover eligibility between surviving non-spouse beneficiaries and surviving spouse beneficiaries (and living participants) serve little purpose and generate confusion among plan and IRA administrators and beneficiaries. For example, IRA administrators often treat all transfers (whether or not an IRA account is a non-spousal inherited IRA) as rollovers, thereby causing confusion for individuals and the Internal Revenue Service. Similarly non-spouse beneficiaries may attempt to move assets to an inherited IRA by means of a 60-day rollover.

## **Proposal**

The proposal would expand the options that are available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited plan or IRA assets to a non-spousal inherited IRA by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The proposal would be effective for distributions made after December 31, 2013.

## **REPEAL NON-QUALIFIED PREFERRED STOCK (NQPS) DESIGNATION**

### **Current Law**

In 1997, Congress added a provision to section 351 that treats NQPS as taxable “boot” for certain purposes. In addition to its treatment as boot in corporate organizations, NQPS is also treated as boot in certain shareholder exchanges pursuant to a plan of corporate reorganization. NQPS is stock that (i) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (ii) has a dividend rate that varies with reference to an index, or, in certain circumstances, a put right, a call right, or a mandatory redemption feature. The addition of this provision reflected the belief that the receipt of certain types of preferred stock more appropriately represented taxable consideration because the investor/transferor obtained a more secure form of investment.

### **Reasons for Change**

NQPS is treated like debt for certain limited purposes but is otherwise generally treated as stock. This hybrid nature of NQPS has transformed it into a staple of affirmative corporate tax planning: its issuance often occurs in loss-recognition planning, where NQPS is treated as debt-like boot, or to avoid the application of a provision that treats a related-party stock sale as a dividend. Thus, for the unwary, the designation and treatment of NQPS represents a proverbial trap that adds additional complexity to the Internal Revenue Code (Code), while for the well-advised, the issuance of NQPS often arises in transactions that are inconsistent with the original purpose of the 1997 provision.

### **Proposal**

The proposal would repeal the NQPS provision and other cross-referencing provisions of the Code that treat NQPS as boot.

The proposal would be effective for stock issued after December 31, 2013.

## **REPEAL PREFERENTIAL DIVIDEND RULE FOR PUBLICLY OFFERED REAL ESTATE INVESTMENT TRUSTS (REITS)**

### **Current Law**

REITs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a “preferential dividend.” For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. Previously, a similar rule had applied to all regulated investment companies (RICs). Section 307 of the Regulated Investment Company Modernization Act of 2010 repealed application of that rule for publicly offered RICs.

### **Reasons for Change**

The original purpose of the preferential dividend rule in 1936 was to prevent tax avoidance by closely held personal holding companies. The inflexibility of the rule can produce harsh results for inadvertent deviations in the timing or amount of distributions to some shareholders. Because an attempt to compensate for a preference in one distribution produces a preference in a second offsetting distribution, it is almost impossible to undo the impact of a prior error. As applied to publicly traded REITs and publicly offered REITs, the rule has ceased to serve a necessary function either in preventing tax avoidance or in ensuring fairness among shareholders. Today, for these shareholders, corporate and securities laws bar preferences and ensure fair treatment.

### **Proposal**

The proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if—

- As of the record date of the distribution, the REIT was publicly traded; or
- As of the record date of the distribution—
  - The REIT was required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Act of 1934;
  - Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318); and
  - Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period.

The Treasury Department would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

The proposal would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.

## **REFORM EXCISE TAX BASED ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS**

### **Current Law**

Private foundations that are exempt from federal income tax generally are subject to a 2-percent excise tax on their net investment income. The excise tax rate is reduced to 1 percent in any year in which the foundation's distributions for charitable purposes exceed the average level of the foundation's charitable distributions over the five preceding taxable years (with certain adjustments). Private foundations that are not exempt from federal income tax, including certain charitable trusts, must pay an excise tax equal to the excess (if any) of the sum of the excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. Under current law, private nonoperating foundations generally are required to make annual distributions for charitable purposes equal to 5 percent of the fair market value of the foundation's noncharitable use assets (with certain adjustments). The amount that a foundation is required to distribute annually for charitable purposes is reduced by the amount of the excise tax paid by the foundation.

### **Reasons for Change**

The current "two-tier" structure of the excise tax on private foundation net investment income may discourage foundations from significantly increasing their charitable distributions in any particular year. An increase in a private foundation's distributions in one year will increase the foundation's five-year average percentage payout, making it more difficult for the foundation to qualify for the reduced 1-percent excise tax rate in subsequent years. Because amounts paid by foundations in excise tax generally reduce the funds available for distribution to charitable beneficiaries, eliminating the "two-tier" structure of this excise tax would ensure that a private foundation's grantees do not suffer adverse consequences if the foundation increases its grant-making in a particular year to respond to charitable needs (for example, disaster relief). Such a change would also simplify both the calculation of the excise tax and charitable distribution planning for private foundations.

### **Proposal**

The proposal would replace the two rates of tax on private foundations that are exempt from federal income tax with a single tax rate of 1.35 percent. The tax on private foundations not exempt from federal income tax would be equal to the excess (if any) of the sum of the 1.35-percent excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions would be repealed.

The proposal would be effective for taxable years beginning after the date of enactment.



## **REMOVE BONDING REQUIREMENTS FOR CERTAIN TAXPAYERS SUBJECT TO FEDERAL EXCISE TAXES ON DISTILLED SPIRITS, WINE AND BEER**

### **Current Law**

The Alcohol and Tobacco Tax and Trade Bureau (TTB) collects taxes on distilled spirits, wines, and beer under the Internal Revenue Code (Code).

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA), was enacted into Public Law 109-59 on August 10, 2005. Section 11127, “Quarterly Excise Tax Filing for Small Alcohol Excise Taxpayers” of SAFETEA amended section 5061(d)(4) of the Code so that importers and producers of distilled spirits, wine, and beer with a reasonably expected excise tax liability of \$50,000 or less in a calendar year, who were liable for not more than \$50,000 in such taxes in the preceding calendar year, could file returns and pay taxes within 14 days after the end of the calendar quarter.

The option for small beverage alcohol excise taxpayers (“small taxpayers”) to file and pay taxes quarterly, rather than semi-monthly, currently only applies to withdrawals, removals, and entries (and articles brought into the United States from Puerto Rico) under bond.

Additionally, TTB has administratively allowed eligible wineries who paid excise taxes in an amount less than \$1,000 during the previous calendar year to file taxes annually pursuant to the regulatory bond framework promulgated under the bond authority for wineries in section 5354 of the Code and the tax return period filing authority under section 5061 of the Code.

### **Reasons for Change**

For calendar year 2010, 89 percent (6,732 of 7,567) of beverage alcohol taxpayers (manufacturers, producers, and importers of distilled spirits, wine, and beer) had a tax liability of less than \$50,000. Of these, 2,810 still filed semi-monthly, although they have the option to file quarterly.

Small taxpayers may choose to continue to file taxes semi-monthly because they would have to increase their deferral bond amounts if they were to file taxes quarterly. By eliminating the bond requirements for small taxpayers, quarterly filing would be less burdensome. This would also lessen the burden for TTB in processing the tax payments.

Distilled spirits and beer taxpayers who paid excise taxes in an amount less than \$1,000 during the previous calendar year are not eligible to file taxes annually, as wineries are.

## **Proposal**

The proposal would require any distilled spirits, wines, and beer taxpayer who reasonably expects to be liable for not more than \$50,000 per year in alcohol excise taxes (and who was liable for not more than \$50,000 in such taxes in the preceding calendar year) to file and pay such taxes quarterly, rather than semi-monthly. The proposal would also create an exemption from the bond requirement in the Internal Revenue Code (Code) for these small taxpayers. The proposal includes conforming changes to the other sections of the Code describing bond requirements.

Additionally, the proposal would allow any distilled spirits, wine, or beer taxpayer with a reasonably expected alcohol excise tax liability of not more than \$1,000 per year to file and pay such taxes annually rather than on a quarterly basis. The proposal will create parity among alcohol taxpayers by allowing eligible distilled spirits and beer taxpayers to file annually as well.

The proposal would be effective 90 days after the date of enactment.

## **SIMPLIFY ARBITRAGE INVESTMENT RESTRICTIONS**

### **Current Law**

Section 103 provides generally that interest on debt obligations issued by State and local governments for governmental purposes is excludable from gross income. Section 148 imposes two types of complex arbitrage investment restrictions on investments of tax-exempt bond proceeds pending use for governmental purposes. These restrictions generally limit investment returns that exceed the yield or effective interest rate on the tax-exempt bonds. One type of restriction, called “yield restriction,” limits investment returns in the first instance, and a second type, called “rebate,” requires issuers to repay arbitrage investment earnings to the Federal Government at prescribed intervals. These restrictions developed in different ways over a long period of time, beginning with yield restriction in 1969 and continuing with the extension of the rebate requirement to all tax-exempt bonds in 1986. Various exceptions apply in different ways to these two types of arbitrage restrictions, including exceptions for prompt expenditures of bond proceeds, reasonable debt service reserve funds, small issuers, and other situations.

With respect to spending exceptions, a two-year construction spending exception to arbitrage rebate under section 148(f)(4)(C) applies to certain categories of tax-exempt bonds (including bonds for governmental entities and nonprofit entities, but excluding most private activity bonds). This two-year construction spending exception has semiannual spending targets, bifurcation rules to isolate construction expenditures, and elective penalties in lieu of rebate for failures to meet spending targets. Separately, a longstanding regulatory three-year spending exception to yield restriction is available for all tax-exempt bonds used for capital projects.

A small issuer exception to arbitrage rebate under section 148(f)(4)(D) applies to certain governmental small issuers with general taxing powers if they issue no more than \$5 million in tax-exempt bonds in a particular year. The small issuer exception has been in effect since 1986 without change, except for an increase to \$15 million for certain public school expenditures.

### **Reasons for Change**

The arbitrage investment restrictions create unnecessary complexity and compliance burdens for State and local governments in several respects. In general, the two types of arbitrage restrictions (yield restriction and rebate) are duplicative and overlapping and they have the same tax policy objective to limit arbitrage profit incentives for excess issuance of tax-exempt bonds. While Treasury Regulations have integrated these restrictions partially, further statutory integration of the arbitrage restrictions could provide a simpler and more unified framework.

Moreover, the two-year construction spending exception to arbitrage rebate is extremely complex. This exception has restricted eligibility rules, unduly-short spending targets, and complex penalty elections that are rarely used. A streamlined spending exception could provide meaningful simplification and reduce compliance burdens. Limited arbitrage potential exists if issuers spend proceeds fairly promptly. By comparison, a recent uniform provision for qualified tax credit bonds under section 54A has a simplified three-year spending exception to arbitrage restrictions, along with a requirement to redeem bonds upon a failure to meet the spending rules.

An increase in the small issuer exception to arbitrage rebate would reduce compliance burdens for a large number of State and local governmental issuers while affecting a disproportionately smaller amount of tax-exempt bond dollar volume. For example, in 2008, issuers under a similar \$10 million small issuer exception for bank-qualified tax-exempt bonds under section 265 issued about 39 percent of the total number of tax-exempt bond issues (4,195 out of 10,830 total bond issues), but only 3.9 percent of total dollar volume (\$15.3 billion out of \$389.6 billion).

## **Proposal**

**Unify Yield Restriction and Rebate Further.** The proposal would unify yield restriction and rebate further by relying on arbitrage rebate as the principal type of arbitrage restriction on tax-exempt bonds. The proposal generally would repeal yield restriction, subject to limited exceptions under which yield restriction would continue to apply to investments of refunding escrows in advance refunding issues under section 149(d) and to other situations identified in regulations.

**Broader Streamlined Three-year Spending Exception.** The proposal would provide a broader streamlined three-year spending exception to arbitrage rebate for tax-exempt bonds that meet the following requirements:

(1) **Eligible Tax-exempt Bonds.** Eligible tax-exempt bonds would include all governmental bonds and private activity bonds, excluding only bonds used for advance refundings under section 149(d) or restricted working capital expenditures (as defined in regulations).

(2) **Long-term Fixed Rate Bonds.** The tax-exempt bonds would be required to have a fixed yield and a minimum weighted average maturity of at least five years.

(3) **Spending Period.** The issuer would be required to spend 95 percent of the bond within three years after the issue date.

(This 5 percent de minimis provision broadens the availability exception to cover many circumstances in which minor amounts of bond proceeds remain unspent for bona fide reasons.)

(4) **Due Diligence.** The issuer would be required to satisfy a due diligence standard in spending the bond proceeds.

Upon a failure to meet the spending requirements for this exception, the tax-exempt bond issue would revert to become subject to the arbitrage rebate requirement.

**Increase Small Issuer Exception.** The proposal would increase the small issuer exception to the arbitrage rebate requirement for tax-exempt bonds from \$5 million to \$10 million and index the size limit for inflation. The proposal also would remove the general taxing power constraint on small issuer eligibility.

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

## **SIMPLIFY SINGLE-FAMILY HOUSING MORTGAGE BOND TARGETING REQUIREMENTS**

### **Current Law**

Section 143 allows use of tax-exempt qualified mortgage bonds to finance mortgage loans for owner-occupied single-family housing residences, subject to a number of targeting requirements, including, among others: a mortgagor income limitation (generally not more than 115 percent of applicable median family income, increased to 140 percent of such income for certain targeted areas, and also increased for certain high-cost areas); a purchase price limitation (generally not more than 90 percent of average area purchase prices, increased to 110 percent in targeted areas); refinancing limitation (generally only new mortgages for first-time homebuyers are eligible); and a targeted area availability requirement. In addition, the general restrictions on tax-exempt private activity bonds apply to these qualified mortgage bonds, including, among other restrictions, the State private activity bond volume cap under section 146.

### **Reasons for Change**

The targeting requirements for qualified mortgage bonds are complex and excessive. The mortgagor income limit generally serves as an appropriate limit to target this lower cost borrowing subsidy to a needy class of low and moderate income beneficiaries. The mortgagor income limit typically is a more constraining factor than the purchase price limit. The restriction against refinancing limits the availability of this lower cost borrowing subsidy as a tool to address needs for affordable mortgage loan refinancing within a needy class of existing low and moderate income homeowners.

### **Proposal**

The proposal would repeal the purchase price limitation under section 143(e) and the refinancing limitation under section 143(d) on tax-exempt qualified mortgage bonds.

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

## **STREAMLINE PRIVATE BUSINESS LIMITS ON GOVERNMENTAL BONDS**

### **Current Law**

Section 141 treats tax-exempt bonds issued by State and local governments as governmental bonds if the issuer limits private business use and other private involvement sufficiently to avoid treatment as “private activity bonds.” Bonds generally are classified as private activity bonds under a two-part test if more than 10 percent of the bond proceeds are both (1) used for private business use, and (2) payable or secured from property or payments derived from private business use.

Subsidiary restrictions further reduce the permitted thresholds of private involvement for governmental bonds in several ways. Section 141(b)(3) imposes a 5 percent unrelated or disproportionate private business use limit. Section 141(b)(4) imposes a \$15 million cap on private business involvement for governmental output facilities (such as electric, gas, or other output generation, transmission, and distribution facilities, but excluding water facilities). Section 141(c) imposes a private loan limit equal to the lesser of 5 percent or \$5 million of bond proceeds. Section 141(b)(5) requires a volume cap allocation for private business involvement that exceeds \$15 million in larger transactions which otherwise comply with the general 10 percent private business limits.

### **Reasons for Change**

The 10 percent private business limit generally represents a sufficient and workable threshold for governmental bond status. The volume cap requirement for private business involvement in excess of \$15 million serves as a control on private business involvement in larger transactions.

The particular subsidiary restriction which imposes a 5 percent limit on unrelated or disproportionate private business use introduces undue complexity, a narrow disqualification trigger, and attendant compliance burdens for State and local governments. The 5 percent unrelated or disproportionate private business use test requires difficult factual determinations regarding the relationship of private business use to governmental use in financed projects. This test is difficult to apply, particularly in governmental bond issues that finance multiple projects.

### **Proposal**

The proposal would repeal the 5 percent unrelated or disproportionate private business use test under section 141(b)(3) to simplify the private business limits on tax-exempt governmental bonds.

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

## **EXCLUDE SELF-CONSTRUCTED ASSETS OF SMALL TAXPAYERS FROM THE UNIFORM CAPITALIZATION (UNICAP) RULES**

### **Current Law**

Under the UNICAP rules, taxpayers that produce property for use in their trade or business or produce or acquire property for resale are required to capitalize the direct and indirect costs of the property produced or acquired. The term “produce” includes construct, build, install, manufacture, develop, or improve. A taxpayer is treated as producing any property that is produced for the taxpayer under a contract with the taxpayer. Costs required to be capitalized under the UNICAP rules include direct costs of property produced, a proper share of certain indirect costs allocable to the property produced, and, in certain cases, allocable interest costs. Direct costs include the costs of materials that become an integral part of the item and that are consumed in the ordinary course of the activity, and the cost of labor that can be identified or associated with the activity, such as basic compensation, overtime pay, vacation pay, and payroll taxes. Indirect costs include all other costs, such as repair and maintenance of equipment or facilities, utilities, rental fees, depreciation, amortization, supervisory wages, administrative costs, pension contributions, and engineering and design expenses. The regulations provide that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production.

The UNICAP rules contain a number of exceptions. For example, personal property acquired by a taxpayer for resale is not subject to the UNICAP rules if the average annual gross receipts of the taxpayer do not exceed \$10 million. A *de minimis* rule treats producers with total indirect costs of \$200,000 or less as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Other rules exempt produced inventory of certain small producers from the UNICAP capitalization requirements.

### **Reasons for Change**

The identification of capitalizable costs and the methods for allocating indirect costs, as well as rules relating to interest capitalization, are complex and require a sophisticated knowledge of the tax law. Appropriate use of allocation methodologies, interest capitalization, and overall compliance with the UNICAP rules is a frequent source of controversy between the Internal Revenue Service and taxpayers.

Because of the breadth of activities that constitute production under the UNICAP rules, and other complexities in complying with these rules, many small taxpayers that improve or construct tangible property for use in their trade or business (self-constructed assets) are unknowingly subject to UNICAP. Compliance with UNICAP is a significant burden for such taxpayers, as general accounting principles would not otherwise require capitalization of many UNICAP costs or use cost allocation methodologies that are appropriate under UNICAP. Further, even small taxpayers that may be able to identify costs required to be capitalized under these general requirements may not have adequate recordkeeping capabilities or tax department resources to comply with the additional UNICAP requirements for self-constructed assets.

An exception for small taxpayers from the requirements of UNICAP with respect to self-constructed assets would relieve both small taxpayers and tax administrators from devoting valuable resources to compliance and enforcement activities. In addition, such an exception would allow small taxpayers to invest in improving or constructing new business assets without incurring costs to comply with UNICAP and will allow certain otherwise deductible indirect costs related to production to be expensed in the year incurred (instead of being recovered as part of the asset's basis).

### **Proposal**

The proposal would exempt taxpayers having average annual gross receipts of \$10 million or less from the application of the UNICAP rules for costs incurred to produce real or personal property (including property produced for the taxpayer under a contract with another party) for use by the taxpayer in its trade or business. Average annual gross receipts would be calculated based on the taxpayer's three-previous taxable years. All persons treated as a single employer under current statutory rules would be treated as a single taxpayer for the purpose of this test. The proposal would not exempt costs incurred in the taxpayer's production of property that is held for sale.

The proposal would be effective for costs incurred in taxable years beginning after December 31, 2013.



## **REPEAL TECHNICAL TERMINATIONS OF PARTNERSHIPS**

### **Current Law**

Under section 707(b)(1)(B) of the Internal Revenue Code, if within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits, the partnership is treated as having terminated for U.S. federal income tax purposes.

### **Reasons for Change**

A termination of this kind is commonly referred to as a “technical termination” because the termination occurs solely for U.S. federal income tax purposes, even though the entity continues to exist for local law purposes and the business of the partnership continues. Even though the business of the partnership continues in the same legal form, several unanticipated consequences occur as a result of a technical termination, including, among other things, the restart of section 168 depreciation lives, the close of the partnership’s taxable year, and the loss of all partnership level elections. Accordingly, this rule currently serves as a trap for the unwary taxpayer or as an affirmative planning tool for the savvy taxpayer.

### **Proposal**

The proposal would repeal section 708(b)(1)(B) effective for transfers on or after December 31, 2013.

## **REPEAL ANTI-CHURNING RULES OF SECTION 197 OF THE INTERNAL REVENUE CODE**

### **Current Law**

In 1993, Congress enacted section 197 of the Internal Revenue Code to allow the amortization of certain intangibles (such as goodwill and going concern value). Prior to the enactment of section 197, such intangibles were not amortizable. To “prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under [prior] law into amortizable property,” Congress enacted section 197(f)(9), which excludes an intangible from the definition of amortizable section 197 intangible if (1) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the “transition period”), by the taxpayer or related person; (2) the taxpayer acquired the intangible from a person who held it at any time during the transition period, and, as part of the transaction, the user of the intangible does not change; or (3) the taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

### **Reasons for Change**

The rules under section 197(f)(9) are complex. Because it has been almost 20 years since the enactment of section 197, most of the intangibles that exist today did not exist during the transition period and, thus, would not be subject to section 197(f)(9). Even though the number of intangibles subject to section 197(f)(9) may be minor, taxpayers must nevertheless engage in due diligence to determine whether such intangibles exist and then navigate the complex rules of section 197(f)(9). Accordingly, the complexity and administrative burden associated with section 197(f)(9) outweighs the current need for the provision.

### **Proposal**

The proposal would repeal section 197(f)(9) effective for acquisitions after December 31, 2013.

## **USER FEE**

### **REFORM INLAND WATERWAYS FUNDING**

#### **Current Law**

The Inland Waterways Trust Fund is authorized to pay 50 percent of the capital costs of the locks and dams and other features that make commercial transportation possible on the inland and intracoastal waterways. This trust fund is supported by a 20-cents-per-gallon excise tax on liquids used as fuel in a vessel in commercial waterway transportation. The excise tax applies to commercial waterway transportation on a waterway listed in section 206 of the Inland Waterways Revenue Act of 1978, as amended. Commercial waterway transportation is defined as any use of a vessel on a listed waterway: (1) in the business of transporting property for compensation or hire; or (2) in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage). Exceptions are provided for deep-draft ocean-going vessels, passenger vessels, State and local governments, and certain ocean-going barges.

#### **Reasons for Change**

The fuel excise tax does not raise enough revenue to pay the full amount of the authorized expenditures from this trust fund. Moreover, the tax is not the most efficient method for financing expenditures on those waterways. Additional funding to supplement the amount collected from the excise tax can be provided through a more efficient user fee system.

#### **Proposal**

The Administration proposes to reform the laws governing the Inland Waterways Trust Fund, including establishing a new user fee. The proposal would increase the amount paid by commercial navigation users sufficiently to meet their share of the costs of activities financed from this trust fund. The Secretary of the Army would set the amount of the user fee each year to collect a total of \$1.1 billion from the user fee over the first 10 years. Thereafter, the Secretary of the Army would adjust the user fee over time, so that the combined amount collected from the excise tax and the user fee covers the user-financed share of spending for inland waterways construction, replacement, expansion, and rehabilitation work.

## **OTHER INITIATIVES**

### **ALLOW OFFSET OF FEDERAL INCOME TAX REFUNDS TO COLLECT DELINQUENT STATE INCOME TAXES FOR OUT-OF-STATE RESIDENTS**

#### **Current Law**

Generally, the Treasury will provide a refund of any overpayment of Federal tax made by a taxpayer (by withholding or otherwise). The overpayment amount is reduced by (i.e., offset by) debts of the taxpayer for past-due child support, debts to Federal agencies, fraudulently obtained unemployment compensation, and past-due, legally enforceable State income tax obligations. In the latter case, a refund offset is permitted only if the delinquent taxpayer resides in the State seeking the offset.

#### **Reasons for Change**

Under current law, a delinquent taxpayer can escape offset of a Federal refund for a State tax liability as long as the taxpayer is not a resident of the State. Foreclosing this possibility would better leverage the capacity of the Federal tax refund offset program for the country as a whole.

#### **Proposal**

The proposal would permit offset of Federal refunds to collect State income tax, regardless of where the delinquent taxpayer resides.

The proposal would be effective on the date of enactment.

## **AUTHORIZE THE LIMITED SHARING OF BUSINESS TAX RETURN INFORMATION TO IMPROVE THE ACCURACY OF IMPORTANT MEASURES OF THE ECONOMY**

### **Current Law**

Current law authorizes the Internal Revenue Service (IRS) to disclose certain federal tax information (FTI) for governmental statistical use. Business FTI may be disclosed to officers and employees of the Census Bureau for all businesses. Similarly, business FTI may be disclosed to officers and employees of the Bureau of Economic Analysis (BEA), but only for corporate businesses. Specific items permitted to be disclosed are detailed in the associated Treasury Regulations. The Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI.

### **Reasons for Change**

BEA's limited access to business FTI and BLS's lack of access to business FTI prevents BEA, BLS, and Census from synchronizing their business lists. Synchronization of business lists would significantly improve the consistency and quality of sensitive economic statistics including productivity, payroll, employment, and average hourly earnings.

In addition, given the growth of non-corporate businesses, especially in the service sector, the current limitation on BEA's access to corporate FTI impedes the measurement of income and international transactions in the National Accounts. The accuracy and consistency of income data are important to the formulation of fiscal policies.

Further, the Census's Business Register is constructed using both FTI and non-tax business data derived from the Economic Census and current economic surveys. Because this non-tax business data is inextricably commingled with FTI, it is not possible for Census to share data with BEA and BLS in any meaningful way.

### **Proposal**

The proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than \$250,000 and of all partnerships. BEA contractors would not have access to FTI.

The proposal would also give officers and employees of BLS access to certain business (and tax-exempt entities) FTI including: taxpayer identification number; name(s) of the business; business address (mailing address and physical location); principal industry activity (including business description); number of employees and total business-level wages (including wages, tips, and other compensation, quarterly from Form 941 and annually from Forms 943 and 944); and sales revenue for employer businesses only. BLS would not have access to individual employee FTI. In other words, the proposal would allow officers and employees of each of BLS, BEA, and Census to access the same FTI for businesses, and would permit BLS, BEA, and Census to share such FTI amongst themselves (subject to the restrictions described below).

For the purpose of synchronizing BLS and Census business lists, the proposal would permit employees of state agencies to receive from BLS the following FTI identity items: taxpayer identification number, business name(s), business address(es), and principal industry activity (including business description). No BLS contractor or State agency contractor would have access to FTI.

The proposal would require any FTI to which BEA and BLS would have access, either directly from IRS, from Census, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act (CIPSEA). The three statistical agencies and state agencies would be subject to taxpayer privacy law, safeguards, and penalties. They would also be subject to CIPSEA confidentiality safeguard procedures, requirements, and penalties. Conforming amendments to applicable statutes would be made as necessary to apply the taxpayer privacy law, including safeguards and penalties to BLS as well as Census and BEA. BLS would be required to monitor compliance by state agencies with the prescribed safeguard protocols.

The proposal would be effective upon enactment.

## **ELIMINATE CERTAIN REVIEWS CONDUCTED BY THE U.S. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (TIGTA)**

### **Current Law**

Section 7803(d) requires TIGTA to conduct reviews of certain administrative and civil actions and reviews of Internal Revenue Service (IRS) compliance with respect to certain requirements in order to comply with TIGTA's reporting requirements.

### **Reasons for Change**

The statutory reviews that are proposed to be eliminated are of relatively low value and yield little in the way of performance measures. In order to make more efficient use of TIGTA's resources, TIGTA would prefer to redirect the resources applied to conduct these reviews to conducting high-risk audits.

### **Proposal**

As requested by TIGTA, the proposal would eliminate TIGTA's obligation to report information regarding any administrative or civil actions related to Fair Tax Collection Practices violations in one of TIGTA's Semiannual Reports, review and certify annually that the IRS is complying with the requirements of section 6103(e)(8) regarding information on joint filers, and annually report on the IRS's compliance with sections 7521(b)(2) and (c) requiring IRS employees to stop a taxpayer interview whenever a taxpayer requests to consult with a representative and to obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative has unreasonably delayed the completion of an examination or investigation.

The proposal would revise the annual reporting requirement for all remaining provisions in the IRS Restructuring and Reform Act of 1998 to a biennial reporting requirement.

The proposal would be effective after December 31, 2013.

## **MODIFY INDEXING TO PREVENT DEFLATIONARY ADJUSTMENTS**

### **Current Law**

Many parameters of the tax system – including the size of personal exemptions and standard deductions, the width of income tax rate brackets, the amount of certain other deductions and credits, and the maximum amount of various saving and retirement deductions – may be adjusted annually for the effects of inflation. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for all Urban Consumers (CPI-U). Depending on the particular tax parameter, the adjustment may be based on CPI-U for a particular month, its average for a calendar quarter, or its average for a 12-month period (with various ending dates). The adjusted values are rounded differently, as specified in the Internal Revenue Code (Code).

When inflation adjustment of tax parameters was enacted, it was generally contemplated that indexing would result in upward adjustments to reflect inflation. If price levels decline for the year, the inflation adjustment provisions for most adjusted tax parameters permit the tax parameters to become smaller, so long as they do not decline to less than their base period values specified in the Code. However, the statutory provisions for the indexing of those tax parameters adjusted pursuant to section 415(d) (generally relating to benefits and contributions under qualified plans) are held at their previous year's level if the relevant price index declines. In subsequent years, they increase only to the extent that the relevant price index exceeds its highest preceding relevant level.

### **Reasons for Change**

Between 2008 and 2009, for the first time since inflation adjustments were enacted, the annual index values used for two of the indexing methods declined for the relevant annual period. The index level relevant for section 415(d) adjustments fell, but by statute those parameters remain at their 2009 levels for 2010. (They did not increase for 2011.) Also, the maximum size of a cash method debt instrument, as adjusted under section 1274A(d)(2) decreased for 2010. Other tax parameters did not decrease, since the price index relevant for their adjustments did not decline between 2008 and 2009.

The 2008 to 2009 price index changes demonstrate that a year-to-year decrease is possible. Preventing tax parameters from falling if the underlying price levels fall would make the tax system a more effective automatic economic stabilizer than it is under current law. Holding tax parameters constant would also prevent reductions in certain tax benefits for saving and retirement which should not be affected by short-term price level reductions.

### **Proposal**

The proposal would modify inflation adjustment provisions so as to prevent tax parameters from declining from the previous year's levels if the underlying price index falls. Future inflation-related increases would be based on the highest previous level of the price index relevant for adjusting the particular tax parameter. Another Administration proposal would change the price index used for inflation adjustments to the chained CPI.



The proposal would be effective beginning on the date of enactment.

## **REPLACE THE CONSUMER PRICE INDEX (CPI) WITH THE CHAINED CPI FOR PURPOSES OF INDEXING TAX PROVISIONS FOR INFLATION**

### **Current Law**

Under current law, many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. These inflation-indexed tax parameters include the dollar value of the personal exemption and the standard deduction, the income thresholds for the individual income tax rate brackets, and the income thresholds and phase-out ranges for a number of deductions, exclusions, and tax credits.

Most of the adjustments are based on annual changes in the level of the CPI for all Urban Consumers (CPI-U). The CPI-U is an index that measures prices paid by typical urban consumers on a broad range of products. Depending on the particular tax parameter, the adjustment may be based on the CPI-U for a particular month, its average for a calendar quarter, or its average for a 12-month period (with various ending dates). The adjusted values are rounded differently, as specified in the Internal Revenue Code.

### **Reasons for Change**

The CPI-U typically overstates the effects of inflation because it does not fully reflect changes in consumption patterns in response to relative price changes. The chained CPI-U (C-CPI-U) would account more fully for this substitution effect and therefore better reflect changes in the cost of living.

Other Administration proposals would change the indexing of many Federal retirement programs and other expenditure programs from either CPI-W (an index of prices faced by urban wage earners) or CPI-U to the chained CPI-U.

### **Proposal**

The proposal would use the C-CPI-U to index tax parameters currently indexed by the CPI-U.

The proposal would be effective for taxable years beginning after December 31, 2014.

Another Administration proposal would prevent indexed tax parameters from declining if there is a year-to-year decrease in the index used to adjust tax parameters for inflation.