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DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee Staff"), provides a description and analysis of certain revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are included in the President's fiscal year 2014 budget proposal, as submitted to the Congress on April 10, 2013.[2] Because many of the provisions in the 2014 budget proposal are substantially similar or identical to the fiscal year 2013 budget proposal, the Joint Committee Staff has described only those provisions that did not appear in the fiscal year 2013 budget proposal or that are substantially modified.[3] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget revenue proposals.[4] For new provisions, there is a description of present law and the proposal (including effective date), and a discussion of policy issues related to the proposal. For modified provisions, there is a description of the modification, and a footnote directing the reader to the Joint Committee Staff's description of the revenue provision as it appeared in the fiscal year 2013 budget proposal.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2014: Analytical Perspectives* (H. Doc. 113-3, Vol. III), April 10, 2013, pp. 182-218.

[3] The revenue provisions contained in the fiscal year 2013 budget proposal are described in their entirety in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012.

[4] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, April 2013.

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

A. Permanently Extend the American Opportunity Tax Credit

Description of Modification

The fiscal year 2013 budget proposal is modified by removing the inflation adjustment for the amount of eligible qualified tuition and the phase-out thresholds (as is the case under present law).[5]

[5] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 34.

PART II − INCENTIVES FOR MANUFACTURING, RESEARCH, CLEAN ENERGY, AND INSOURCING AND CREATING JOBS

A. Provide New Manufacturing Communities Tax Credit

Description of Modification

The fiscal year 2013 budget proposal is modified by changing the effective date such that the credit is allowed for investments made after December 31, 2013, and before December 31, 2017.[6]

[6] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 83-87.

B. Permanently Extend the Work Opportunity Tax Credit and the Indian Employment Credit

Description of Modification

The fiscal year 2013 budget proposal is modified by permanently extending the Work Opportunity Tax Credit and the Indian Employment Credit, rather than extending these credits only through 2013.[7]

[7] The Work Opportunity Tax Credit is described in Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* (JCS-2-13), February 2013, p. 151. The Indian Employment Credit is described in Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* (JCS-2-13), February 2013, p. 144.

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

Description of Modification

The fiscal year 2014 budget proposal modifies the prior year budget proposal by permanently extending the renewable electricity production tax credit and allowing new solar power facilities to qualify for that credit.[8] The fiscal year 2013 budget proposal proposed making both the section 45 renewable electricity production credit and the section 48 energy credit refundable. The fiscal year 2014 budget proposal continues to support refundability for the section 45 renewable electricity production credit but not for the section 48 energy credit.

[8] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 124.

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

Present Law

In general

Code section 179D provides an election under which a taxpayer may take an immediate deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property is defined as property (1) which is installed on or in any building located in the United States that is within the scope of 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"), (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, and (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 systems, 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 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual.

The Secretary is granted authority to prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems.[9] Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is allowed under this section, the basis of the property is reduced by the amount of the deduction.

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[9] See Notice 2006-52, 2006-1 C.B. 1175, June 2, 2006; Notice 2008-40, 2008-14 I.R.B. 725, March 11, 2008.

The deduction is effective for property placed in service prior to January 1, 2014.

Partial allowance of deduction

System-specific deductions

In the case of a building that does not meet the overall building requirement of 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary. The applicable system-specific savings targets to be established by the Secretary 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 separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.60 per square foot for each separate system.

Interim rules for lighting systems

In general, in the case of system-specific partial deductions, no deduction is allowed until the Secretary establishes system-specific targets.[10] However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in lighting power density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions under the interim rule.

Corporate earnings and profits effect

Earnings and profits are the measure of corporate economic income that, if distributed to shareholders, generally is taxed to them as a dividend (rather than as a return of their corporate

[10] Notice 2008-40, *supra*, set a target of a 10-percent reduction in total energy and power costs with respect to the building envelope, and 20 percent each with respect to the interior lighting system and the heating, cooling, ventilation and hot water systems. Notice 2012-26 (2012-17 I.R.B. 847, April 23, 2012) established new targets of 10-percent reduction in total energy and power costs with respect to the building envelope, 25 percent with respect to the interior lighting system and 15 percent with respect to the heating, cooling, ventilation and hot water systems, effective beginning March 12, 2012. The targets from Notice 2008-40 may continue to be used until December 31, 2013, but only the new targets of Notice 2012-26 will be available under any extension of section 179D beyond December 31, 2013.

stock basis or as capital gain in excess of basis).[11] Although earnings and profits generally are the same as taxable income in a current year, this is not always the case. Special rules for certain types of corporate deductions and income require earnings and profits to be reduced or increased over a different period than the period in which the corporation recognizes the deductions or income for purposes of computing its income tax.[12]

If a corporation makes an election under section 179D to deduct expenditures immediately, the full amount of the deduction does not reduce earnings and profits immediately. Instead, the expenditures that were deducted reduce corporate earnings and profits ratably over a 5-year period.[13] Thus, in the year of the expenditure, corporate taxable income is reduced by 100 percent of the expenditure while earnings and profits of a regular C corporation[14] is reduced by only 20 percent of the expenditure. In each of the following four years, earnings and profits will be reduced by 20 percent of the expenditure but taxable income will not be reduced at all since the entire deduction was taken in the year of the expenditure. A special earnings and profits rule for the following four years applies to Real Estate Investment Trusts ("REITs"), as discussed below.

Real Estate Investment Trusts

In general

A REIT is a U.S. entity that would otherwise be taxed in all respects as a regular C corporation but that qualifies and elects to be taxed under a special modified corporate regime. This regime includes many aspects of subchapter C rules, but modifies the rules to create a mechanism that allows the REIT to deduct dividends paid to its shareholders.

In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT taxable income (other than net capital gain) must be distributed as a dividend during the REIT taxable year (or treated as distributed then);[15] the REIT must derive most of its

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[11] Corporate distributions to shareholders are generally treated as a dividend to the extent of current or accumulated earnings and profits. Distributions in excess of that amount first reduce a shareholder's stock basis and thereafter are treated as capital gain with respect to the stock. Sec. 301.

If a distribution is made in exchange for a shareholder's stock, as in a corporate stock redemption, and the redemption reduces the shareholder's interest in the corporation by a sufficient amount so that it is not considered essentially equivalent to a dividend, the shareholder is treated as having sold the stock rather than as having received a dividend. Sec. 302.

[12] See, *e.g.*, secs. 312(k) and 312(n).

[13] Sec. 312(k)(3)(B).

[14] The term "regular" C corporation refers to a corporation that is subject to the rules on subchapter C of the Code without the modifications of those rules applicable to REITs (and to regulated investment companies).

[15] See sec. 858. Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, additional distribution requirements must be met in order to avoid an excise tax under section 4981.

income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. A REIT must have at least 100 shareholders and may not be closely held by individual shareholders.[16] Other requirements also apply.[17]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[18] Although a REIT is not required to distribute more than the 90 percent of its income described above in order to retain REIT status, it will be taxed at ordinary corporate rates on amounts not distributed. Section 4981 also imposes an additional four-percent excise tax to the extent a REIT does not distribute within a calendar year an amount equal to at least 85 percent of REIT ordinary income (as defined) and 95 percent of REIT capital gain net income for the current taxable year, plus the "shortfall" amount by which the preceding calendar year distributions were less than 100 percent of such ordinary income and capital gain net income for the preceding taxable year. Distributions that exceeded the required amount in the prior year are treated as distributions in the current year for purposes of this computation.

Earnings and profits and treatment of REIT and REIT shareholders

REIT shareholders who receive distributions from the REIT are treated as receiving a REIT dividend[19] to the extent the REIT has either current or accumulated earnings and profits.[20] Distributions with respect to REIT stock that are in excess of such earnings and profits of the REIT are treated as a return of shareholders' capital (reducing the shareholders' bases in their REIT stock) and as capital gain of the shareholders with respect to the REIT stock, to the extent they exceed a shareholder's stock basis in the REIT.[21]

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[16] No more than 50 percent of REIT's stock may be held by five or fewer individuals (determined using specified attribution rules). There is no comparable rule restricting ownership by corporate shareholders or by various tax exempt organizations.

[17] Secs. 856 and 857.

[18] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[19] REIT dividends are not qualified dividends eligible for the special dividend rate under section 1(h)(11) except to the extent they are from income subject to tax at the REIT level, or are attributable to qualified dividend income received by the REIT, and are so designated by the REIT as qualified dividends. Sec. 857(c). Other REIT dividends are treated as ordinary taxable income to the shareholder, except to the extent they are designated as "capital gain" dividends from net capital gain of the REIT.

[20] Sec. 301.

[21] Sec. 301.

A REIT may deduct a distribution to shareholders from its taxable income, and can meet the REIT qualification requirement that it distribute as dividends at least 90 percent of its taxable income (other than net capital gain), only to the extent of distributions that are made out of the earnings and profits of the REIT.[22] As noted above, earnings and profits (deemed to be a measure of the economic income of a corporation that can support a taxable dividend to shareholders) are generally computed for corporations (including REITs) under the rules of section 312 and can differ from taxable income. For example, under section 312(k), certain accelerated depreciation deductions (including section 179D deductions) are allowed to be taken in earlier years for purposes of computing a corporation's taxable income than for purposes of computing the corporation's earnings and profits, with the result that current earnings and profits are greater than taxable income in the earlier years, but are less than taxable income in later years.

A special rule for REITs in section 857(d) provides that current REIT earnings and profits will not be reduced by any amount that does not reduce REIT taxable income for the current year.[23] This rule assures that a REIT will always be treated as having enough earnings and profits to make the necessary distributions of 90 percent of taxable income other than net capital gain, and to avoid imposition of any excise tax under section 4981. However, this rule also causes a REIT that elects to accelerate deductions under section 179D[24] to have a greater amount of earnings and profits in each of the four years following the investment than would be the case for a regular C corporation.

A REIT that elected the accelerated section 179D deduction would benefit from that election in that the REIT would be able to retain more cash flow in the first year of the investment, because the REIT would not be required to make a distribution to shareholders in that year to the extent the REIT's taxable income would be reduced under the election. The shareholders also could benefit from the immediate section 179D deduction to the extent the value of their REIT stock, if sold, would reflect the value of the untaxed retained amounts. Like the shareholders of any C corporation, the shareholders of a REIT are not able to receive an immediate distribution from the REIT in the year of the investment that is treated as a return of capital to the full extent of the tax deduction at the REIT level. Rather, the distribution would be a taxable dividend to the extent of the REIT earnings and profits, which have been reduced only by 20 percent of the investment. Unlike the shareholders of a regular C corporation, however, later distributions of REIT taxable income will again be treated as dividends to the shareholders, even though earnings and profits normally would have been reduced below taxable income in later years under general corporate rules of section 312(k). This result occurs because of the

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[22] Secs. 857(a)(1), 857(b) and 561.

[23] Sec. 857(d).

[24] The section 179D election is not the only rule that can have this effect for a REIT. The temporary election to amortize certain leasehold improvements over 15 years has a similar effect. Sec. 168(k) and sec. 312(k)(3)(A). As another example, depreciation of residential buildings is generally taken over 27.5 years, and of commercial buildings over 39 years for tax purposes, but both are depreciated over 40 years for earnings and profits purposes. Sec. 168(c) and sec. 312(k)(3).

special REIT rule of section 857(d)(1) that allows a REIT to have enough current earnings and profits to distribute all of its taxable income in a year.

A REIT that retained the extra cash flow from the section 179D deduction in the year of the investment, and that made distributions only as required with respect to its taxable income in later years, would not experience the effect of the "additional" dividend treatment to its shareholders. However, a REIT that desired to make steady annual distributions to shareholders and not retain the non-taxed income in the first year of a section 179D investment could cause its shareholders to be treated as receiving more dividend income in the aggregate than would be the case otherwise. Such a REIT might not elect to take the special section 179D deduction at all.[25]

Description of Proposal

The proposal would increase the existing deduction amount of $1.80 per square foot to $3.00 per square foot, and increase the partial deduction amount of $0.60 to $1.00. Taxpayers that simultaneously satisfy the energy saving targets for the building envelope and the heating, cooling, ventilation, and hot water systems would be allowed a deduction of $2.20 per square foot.

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

Special rules would be provided that would allow the deduction to benefit a REIT 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.

Effective date.−The proposal applies to property placed in service after December 31, 2013.

[25] If no election under section 179D were made, the property would be depreciated under the generally applicable depreciation rules, and no special rule would apply that causes earnings and profits to differ from taxable income.

Analysis

By increasing the deduction amount, the proposal increases the incentive to design new buildings, or retrofit older buildings, to meet the standards, thus increasing the energy efficiency of commercial buildings. The increased deduction increases the cost of the provision. Some of that increased cost will result from the construction of buildings that would have met the efficiency standards without the added incentive.

The new deduction for existing commercial buildings with at least 10 years occupancy will likely encourage more retrofits of existing buildings. It is argued that, other than for lighting, the standards for the present-law deduction are too stringent for existing buildings due to constraints in the existing architecture of these buildings. By providing a deduction based on energy improvements relative to the existing status of the building, more potential retrofits will be able to factor in tax savings when they consider the costs and benefits of a retrofit, and more retrofits will likely occur as a result. The proposal does not offer a reason for limiting the new deduction for buildings of ten years or greater occupancy. A possible motivation may be that the newer buildings excluded from the deduction are generally already fairly energy efficient and the energy savings of further retrofits would be small relative to potential costs of the deduction.

The new deduction for retrofits will, relative to current law, tilt the balance in favor of retrofits of existing buildings relative to new construction. This may have the positive effect of conserving existing resources (relative to tearing down a building for new construction), though it is possible in some cases that the retrofitted building would remain less efficient that a new one that would have otherwise taken its place. One would need to know the energy costs associated with production of the materials that go into the making of a new building to know whether new construction saves energy on a lifecycle basis relative to a retrofit that requires fewer new materials but results in a less energy efficient building.

To the extent that some retrofits would occur regardless of any deduction, the revenue costs of the deduction may be large relative to the amount of net energy savings produced. For that and other reasons, most economists would prefer a direct tax on energy (or similar mechanisms such as cap and trade programs) if the goal is to reduce energy consumption, rather than indirectly reducing energy consumption by subsidizing specified conservation measures.

The new deduction for retrofits will require new and more complicated administrative procedures for testing the energy efficiency of existing buildings and in determining actual energy use after the retrofit is complete, for establishing whether the appropriate energy savings thresholds have been met. While the proposal does not specify, some questions that may arise in determining actual energy use would be whether adjustments are permitted (or required) if the weather were significantly different from the pre-retrofit testing time, or for other factors not related to the energy-efficiency of the building per se, such as occupancy levels or energy demands of particular tenants.

The as yet unspecified rule that would permit REITs or their shareholders to benefit from the deduction would expand the universe of buildings that could potentially claim the deduction as compared to the present-law deduction. Because the intent of the provision is to encourage energy efficiency in building construction, there is a strong case, as a matter of economic

efficiency, for assuring that any new construction is eligible for the tax benefit if the building meets the requisite criteria. In crafting such a rule for REITs, however, consideration should be given to whether the purpose of the deduction is deemed to be to allow an investing REIT to retain more cash flow to make other investments (as occurs with a regular C corporation), and as is permitted only to the extent of any retained REIT taxable income under the present law section 179D deduction, or whether a REIT should be able to distribute the equivalent of this additional cash flow to shareholders as non-taxed cash. Consideration might also be given to a partnership model for passing through a deduction equivalent to shareholders, with or without a distribution from the entity. However, adopting such a model for REIT shareholders could involve issues with respect to particular types of shareholders that would not benefit from a deduction (for example, tax exempt investors). Such a model could also provide REIT shareholders with advantages not available to partnership investors unless passive loss rules and other limitations on investor use of credits that apply to partnerships are also applied to REIT shareholders.[26]

[26] If the investors had invested in a partnership rather than a REIT, and the partnership had made an investment eligible for a credit, partnership rules could permit an investor to take its allocable share of the credit without receiving any distribution from the partnership—a result that does not occur for a C corporation shareholder (including a REIT shareholder). However, tax-exempt investors, investors that are governments, and foreign investors are not permitted to take an investment tax credit, including through a partnership investment. Secs. 50(b)(3) and 50(b)(4); secs.168(h)(5) and (6). In addition, for passive individual investors and certain trusts, estates, and closely held corporations, the passive loss rules of section 469 generally permit the credit to be used only against passive income from that partnership or other entities (but not against any investment income or active business income). Comparable rules would presumably have to be developed for REIT shareholders. It should be noted that REITs already can provide certain advantages to tax-exempt and foreign investors in real estate, as compared to partnerships. Tax-exempt investors in a real estate partnership would have unrelated business income if the partnership is leveraged (as is commonly the case with real estate investment), a result that REIT investors avoid. Also, foreign investors in a real estate partnership would experience gain subject to tax under the Foreign Investment in Real Property Tax Act of 1980 (sec. 897), a result that can be avoided through certain REIT investments such as a less than five-percent ownership interest in a publicly traded REIT.

PART III − TAX RELIEF FOR SMALL BUSINESS

A. Extend Increased Expensing for Small Business

Description of Modification

The fiscal year 2014 budget proposal modifies the prior year budget proposal by increasing the permanent maximum amount a taxpayer may expense to $500,000.[27] The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the year exceeds $2,000,000. The amounts are indexed for inflation for all taxable years beginning after 2013, as is the dollar limitation on the expensing of sport utility vehicles.

[27] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 741.

PART IV − INCENTIVES TO PROMOTE REGIONAL GROWTH

A. Extend and Modify the New Markets Tax Credit

Description of Modification

The fiscal year 2013 budget proposal is modified by extending the new markets tax credit permanently, with an allocation amount of $5 billion for each calendar year, and allowing the new markets tax credit resulting from qualified equity investments made after 2012 to be used to offset AMT liability.[28]

[28] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 146.

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

Present Law

In general

The low-income housing tax credit ("LIHTC") may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[29] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

Qualified low-income housing project

To qualify for the low-income housing tax credit, the incomes of the tenants must satisfy certain targeting rules similar to the rules for tax-exempt bond financed qualified residential rental projects. Under the LIHTC rules, a project is a qualified low-income housing project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified low-income housing project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The owner must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified low-income housing projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test. In practice, many projects have every unit satisfy the income targeting rules so that the entire project qualifies for the credit.

Present value credit

In general

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

[29] Sec. 42.

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

Special rule

Under a special rule the applicable percentage is set at a minimum of nine percent for newly constructed non-Federally subsidized buildings placed in service after July 30, 2008, with respect to credit allocations made before January 1, 2014.

Substantial rehabilitation requirement

Rehabilitation expenditures paid or incurred by a taxpayer with respect to a low-income building are treated as a separate building and may be eligible for the 70-percent credit if they satisfy the otherwise applicable credit rules. To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 20 percent of the adjusted basis of the building being rehabilitated; or (2) at least $6,000 per low-income unit in the building being rehabilitated. The $6,000 amount is indexed for inflation so it is $6,400 in 2013.

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (*i.e.*, at least $6,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied. This special rule applies only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit.

Calculation of the applicable percentage

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

These credit percentages (used for the 70-percent credit and 30-percent credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

Enhanced credit for certain buildings

Generally, certain buildings (*i.e.*, those located in qualified census tracts, those located in difficult development areas, and those buildings designated by the State housing credit agency as requiring the enhanced credit for such buildings to be financially feasible) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased

to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. Further requirements limit the area that can be qualified census tracts and difficult development areas. The portions of each metropolitan statistical area, or nonmetropolitan statistical area, designated as qualified census tracts cannot exceed an aggregate area having 20 percent of the population of each such statistical area. A comparable rule applies to portions of each such statistical area that are designated as difficult development areas. Buildings designated by the State housing credit agency as requiring the enhanced credit for such buildings to be financially feasible are not subject to either the limitation that applies to qualified census tracts or the limitation applicable to difficult development areas.

Recapture

The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set aside requirement, or the gross rent requirement, or other requirements with respect to the units comprising the set aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Volume limits

A low-income housing tax credit is generally allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. The aggregate credit authority provided annually to each State for calendar year 2013 is $2.25 per resident, with a minimum annual cap of $2,590,000 for certain small population States.[30] These amounts are indexed for inflation. Alternatively, if a project finances at least half of its aggregate basis with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit ("volume cap"), the project does not require an allocation of the low-income housing credit, but the related use of tax-exempt bonds is subject to volume cap limitation.

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

Present Law

Private activity bonds in general

Under present law, gross income generally does not include interest paid on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance

[30] Rev. Proc. 2012-41.

governmental functions or that are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for State and local bonds only applies to private activity bonds if the bonds are issued for certain permitted purposes ("qualified private activity bonds").

State volume cap

Unlike governmental bonds, the aggregate volume of most qualified private activity bonds is restricted by the annual volume cap imposed on issuers within each State.[31] The per-State volume cap rules reflect Congress's intent to control the total volume of tax-exempt bonds issued for private activities. For calendar year 2013, the amount for calculating the volume cap is the greater of $95 multiplied by the State population, or $291,875,000 (the "small population State minimum").

Exceptions from the volume cap are provided for bonds for certain governmentally owned facilities (*e.g.*, airports, ports, high-speed intercity rail, and solid waste disposal) and bonds issued to finance the activities of certain charitable organizations. In addition, bonds for which the Code provides a separate local, State, or national volume limit are not subject to the volume cap (*e.g.*, public/private educational facility bonds, enterprise zone facility bonds, qualified green building bonds, and qualified highway or surface freight transfer facility bonds).

If an issuer's volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the issuing authority may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.[32] Carryforwards of unused volume cap are valid for three years.

Description of Proposal

The proposal permits a State to convert a portion of its private activity bond volume cap for a calendar year into additional aggregate allocable low-income housing credit authority for

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[31] Sec. 146.

[32] Sec. 146(f)(5). Qualified governmental units can elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs"). Sec. 25. MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue $200 million of qualified mortgage bonds, and that elected to exchange $100 million of that bond authority, could distribute an aggregate amount of MCCs equal to $25 million.

the same calendar year. For each $1,000 of private activity bond volume cap surrendered, the State receives additional aggregate allocable low-income housing credit authority equal to $1,000 times twice the applicable percentage prescribed by the Secretary in determining the 30-percent present value credit for December of the preceding calendar year.

For example, in a zero-interest-rate environment, the applicable percentage for the 30-percent credit is three percent. In this case, a State may convert $1,000 of private activity bond volume cap into $60 of additional aggregate allocable low-income housing credit authority.

The aggregate amount of private activity bond volume cap that each State may convert with respect to a calendar year is limited to seven percent of the private activity bond volume cap that the State receives for that year.

Effective date.−The proposal is effective for private activity bond volume cap received in, and additional low-income housing tax credit allocation authority received for, calendar years beginning after the date of enactment.

Analysis

The proposal allows States to increase the supply of 70-percent credits in exchange for reducing the volume of private activity bonds that the State may issue. If such bonds were used to finance at least 50 percent of the aggregate basis of projects otherwise eligible for the low-income housing tax credit, those projects would be eligible for 30-percent credits. Thus, the proposal allows States to swap lower-rate credits for some portion of higher-rate credits.

Utilization of this provision depends on the extent to which States have unused private activity volume cap (or the extent to which the alternative uses for the volume cap are valued less than as additional aggregate allocable low-income housing credit authority) and the relative "price" of the 70-percent credits as determined by the conversion ratio. In a zero-interest rate environment, if $1,000 of private activity bonds finances a building with aggregate basis of $2,000, all of which is qualified basis, then the building produces $60 of credits each year for ten years. Under the proposal, a State could trade $1,000 of private activity bond volume cap for an increase in the credit ceiling of additional allocable low-income housing tax credits amounting to an extra $60 of credits each year for ten years. That $60 of credits could apply to approximately $857 of qualified basis.

There is ambiguity in how the proposal interacts with the subsequent proposal that modifies the credit percentages for allocated credits. Under that proposal (described below), the credit percentage for the 70-percent and 30-percent allocated credits increase relative to those under present law, but there is no increase in the applicable percentage for 30-percent credits derived from bond financing. If both proposals are adopted, the proposal should clarify which applicable percentage should be used for purposes of converting volume cap into additional credits.

2. Change formulae for 70-percent present value and 30-percent present value low-income housing tax credits

Description of Proposal

The proposal increases the discount rate used in the present value calculation for allocated LIHTCs. The discount rate to be used is the average of the mid-term and long-term applicable Federal rates for the relevant month, plus 200 basis points. The change applies to both 70-percent and 30-percent allocated LIHTCs. However, the 30-percent present value credit rate for LIHTCs that result from tax-exempt bond financing continues to be computed as under present law.

Effective date.−The proposal is effective for allocations made after December 31, 2013.

Analysis

Under present law, the discount rate used to determine the applicable percentage of the credit rate is 72 percent of the average of the annual applicable Federal rates ("AFR") for mid-term and long-term obligations. Under the proposal, the discount rate is increased to the average of the mid-term and long-term applicable Federal rates plus 200 basis points. This has the effect of placing less weight on the credits earned in later years, thus requiring a higher applicable percentage to produce a credit on a present value basis that is equal to 70 percent (or 30 percent) of the qualified basis of a low-income housing building. The proposal thus makes the LIHTC more valuable to the investor.

The determination of an appropriate interest rate to discount credits to be received in the future is a critical feature of the formula to achieve the stated objective of producing a stream of credits that have a present value equal to a fixed percentage of the qualified basis of a building. If the chosen discount rate is too low, then the stream of credits will not provide the intended subsidy to low-income housing. Conversely, if the discount rate is too high, then the program will provide a greater subsidy to low-income housing than Congress intends.

Choosing an appropriate discount rate is not an easy exercise. The discount rate should reflect the opportunity cost for the taxpayer receiving the credits. This is a function of the riskiness of the cash flows being discounted, the source of funding for the taxpayer, whether the cash flows are in nominal terms or are adjusted for inflation. The fact that there is little doubt that the taxpayer will receive the credits argues for a relatively low discount rate.

According to the legislative history, the discount rate is computed on an after-tax basis as the product of the average AFR and 0.72 (one minus the maximum individual Federal income tax rate).[33] Implicitly this calculation assumes that the average AFR is a reasonable pre-tax interest rate. Using the same methodology, based on the current maximum individual Federal income tax rate, the discount rate would be about 60 percent of the average AFR, rather than the

[33] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 155.

average AFR plus 200 basis points. Based on the current maximum corporate Federal income tax rate, the discount rate would be about 65 percent of the average AFR.

3. Add preservation of Federally assisted affordable housing to allocation criteria

Present Law

Each State must develop a qualified allocation plan for allocating low-income housing credits, and such plan must include certain allocation criteria including: (1) project location; (2) housing needs characteristics; (3) project characteristics, including whether the project includes the use of existing housing as part of a community revitalization plan; (4) sponsor characteristics; (5) tenant populations with special housing needs; (6) public housing waiting lists; (7) tenant populations of individuals with children; (8) projects intended for eventual tenant ownership; (9) the energy efficiency of the project; and (10) the historic nature of the project.

Description of Proposal

The proposal adds preservation of Federally assisted affordable housing as an eleventh selection criterion that a qualified allocation plan must include.

Effective date.−The proposal is effective for allocations made in calendar years beginning after the date of enactment.

Analysis

The proposal may bias the allocation of credits toward projects that preserve Federally assisted affordable housing and away from projects that would otherwise receive credits. This shift may result in projects that are less efficient in providing low-income housing (otherwise such projects would have received allocations in the absence of this additional constraint). This loss in efficiency may be worthwhile if it results in the satisfaction of some other policy objective. It is not clear whether the preservation of existing Federally assisted affordable housing (as opposed to new construction or rehabilitation as defined under the program) "will more effectively serve both low-income individuals and owners willing to provide affordable low-income housing[,]" the stated Congressional intent of the credit.[34]

[34] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 153.

PART V − REFORM U.S. INTERNATIONAL TAX SYSTEM

An analysis of the President's fiscal year 2014 budget proposals to reform the U.S. International tax system may be found in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012.

PART VI − REFORM TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS

A. Require that Derivative Contracts be Marked to Market with Gain or Loss Treated as Ordinary

Present Law

In general

A derivative is a contract requiring at least one payment calculated from the value of something (or a combination of things) that is measured after the contract is entered into. The thing that fixes the payment amount(s) and hence the derivative's value is called the underlying; examples include assets, liabilities, indices, and events. The most common forms of derivative are options, forwards, futures and swaps. Derivatives are flexible and can be adapted to meet contracting parties' needs, including tax planning. The taxation of derivatives has emerged piecemeal with no consistent underlying policy. The rules are different depending on the form of the derivative, the type of taxpayer entering into it, the purpose of the transaction, and other factors. The rules are complex and may be uncertain in their application.

Options

An option is a derivative in which one party purchases the right to deliver or receive a specified thing to or from another party on a fixed date or over a fixed period of time in exchange for a payment whose value is fixed when the contract is signed. The purchaser of the option is also called the holder; the seller of the option is also called the writer or issuer. When the option purchaser gives or receives the specified thing to the other party in exchange for the payment, the purchaser is said to exercise its right. The latest time the purchaser can exercise its right is called the expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the purchaser for the option is called the premium, and the payment made for the thing at expiration is called the strike price. A European-style option is an option that can only be exercised at the expiration date. An American-style option is an option that can be exercised at any time prior to the expiration date.

A call option is an option in which the option purchaser has the right to buy a specified thing. A put option is an option in which the option purchaser has the right to sell a specified thing. Payment at the expiration date can take many forms. An option is called "physically settled" when the underlying is delivered from one party to the other. An option is called "cash settled" when one party pays cash equal to the difference between the strike price and the value of the underlying at the expiration date.

In general,[35] no tax consequences are recognized upon entering into an option contract, even though option premiums are paid without any possibility for recovery or return. The option

[35] This discussion does not address options granted in connection with the performance of services.

purchaser's premium payment is nondeductible, and the option seller does not include the premium payment in income. [36]

For both option seller and purchaser, the premium is taken into account when the option is sold, exercised or expires without exercise. If the option is sold, the premium is accounted for in calculating gain or loss on sale. For the purchaser of a put option, if the option is exercised, the premium reduces the amount received in the sale of the underlying. For the purchaser of a call option, if the option is exercised, the premium becomes part of the basis in the property acquired.

For an option purchaser, gain or loss attributable to the sale or exchange or loss from failure to exercise an option is gain or loss from property of the same character as the option's underlying.[37] An option is treated as sold or exchanged on the day it expires without exercise in determining whether the loss is short term or long term.[38] A seller of an option has ordinary income if the option is not exercised,[39] but if the option is with respect to "property," any gain or loss from closing or lapse is short term capital gain.[40] "Property" includes stocks, securities, commodities and commodity futures.[41] If an option purchaser exercises a cash settled option, then gain or loss is short term or long term depending on whether it has held the option for more than one year.[42] If an option purchaser exercises a physically settled option the holding period for the property delivered is calculated from the date the option is exercised.[43] Option purchasers may be treated differently depending on whether they hold cash settled or physically settled options, even though their economic positions may be similar.[44]

Timing and character results for options and the other derivatives described below may be different depending on the type of taxpayer entering into the option (for example, whether a

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[36] Rev. Rul. 78-182, 1978-1 C.B. 265.

[37] Sec. 1234(a).

[38] Sec. 1234(a)(2).

[39] Treas. Reg. sec. 1.1234-1(b).

[40] Sec. 1234(b).

[41] Sec. 1234(b)(2)(B).

[42] Rev. Rul. 88-31, 1988-1 C.B. 302.

[43] *Ibid.* The new holding period begins on the day the option is exercised if the underlying is stock or other securities acquired from the corporation that issued the securities. Sec. 1223(5). Otherwise, the holding period begins the day after the option is exercised. *Weir v. Commissioner*, 10 T.C. 996 (1948).

[44] An investor who holds a cash settled option for a period longer than one year and who exercises that option is eligible for long term capital gains. If an investor holds a physically settled option for a period longer than one year, exercises the option, and sells the underlying asset immediately, any capital gain on the transaction is short term capital gain to the investor.

dealer in securities), on the use of the option (for example, as a hedge), the underlying, the type of option (whether governed by section 1256), or the application of other overriding rules (for example, the straddle rules).

Forwards

A forward is a derivative in which one party agrees to deliver a specified thing to another party on a fixed date in exchange for a payment whose value is fixed when the contract is signed. The party that agrees to deliver the thing is called the short party; the party that agrees to pay for that thing is called the long party. The time the short party must deliver is called the delivery date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the long party at delivery is called the forward price. For most forwards, no payment is made when the contract is signed. In the case of a prepaid forward, the long party pays the short party the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[45] A variable forward requires the short party to deliver an amount of property that varies according to a formula agreed to when the contract is signed.[46]

A forward is called "physically settled" when the underlying is delivered from one party to the other. A forward is called "cash settled" when one party pays cash equal to the difference between the forward price and the value of the underlying at the delivery date.

In general, no tax consequences are recognized upon entering into a forward.[47] If a forward is physically settled, the short party recognizes gain or loss in the amount of the difference between the forward price and the short party's basis in the property.[48] The long party reflects the forward price as the basis in the property acquired; any gain or loss is deferred until a subsequent realization event.

In general, the character of the gain or loss with respect to a forward is the same as the character of the property delivered.[49] Gain or loss on the sale or exchange of a forward is long

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[45] See Notice 2008-2, 2008-1 C.B. 252.

[46] See, for example, *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 2011).

[47] However, if the forward buyer obtains possession of the underlying property prior to the delivery date specified in the contract, the transaction may be considered "closed" for tax purposes, and the transfer of possession may be treated as a realization event. See, for example, *Commissioner v. Union P. R. Co.*, 86 F.2d 637 (2d Cir. 1936) and *Merrill v. Commissioner*, 40 T.C. 66 (1963).

[48] Sec. 1001.

[49] Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

term capital gain or loss if the contract has been held for longer than the requisite holding period.[50] Cash settlement of a forward is treated as a sale or exchange.[51]

If a forward qualifies as a commodity futures contract not subject to section 1256,[52] the long party's holding period of the underlying includes the period in which the party held the contract.[53] For other physically settled forwards, holding period of the underlying begins when the burdens and benefits of ownership are from a practical standpoint, transferred from the short to the long party.[54] In making this burdens and benefits determination, "no hard-and-fast rules of thumb can be used, and no single factor is controlling."[55] In a case involving a physically settled forward for the sale of convertible debentures, one court held that the long party's holding period with respect to the debentures did not begin until delivery of the underlying debentures where: (1) the short party continued to receive interest payments on the debentures while the forward was open; (2) the short party was free to sell the debentures while the contract was open (provided that the short party delivered substantially identical property on the delivery date); and (3) the short party was free to use the debentures as security for other financial transactions.[56] For short parties to physically settled securities forwards and commodities futures, section 1233 and the accompanying regulations provide rules regarding holding period determinations,[57] although these rules have been partially supplanted by section 1234B (governing certain securities futures contracts) and section 1256 (governing regulated commodities futures contracts). For transactions to which section 1233 still applies, a short party that physically delivers property to close a contract recognizes capital gain or loss on the transaction as short term or long term depending on the period for which the short party holds the property prior to delivery.[58] Accordingly, if a short party closes out a physically settled contract by purchasing

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[50] *Carborundum Co. v. Commissioner*, 74 T.C. 730, 733-42 (1980); *American Home Products Corp. v. United States*, 220 Ct. Cl. 369, 383-87 (Ct. Cl. 1979); *Hoover Co. v. Commissioner*, 72 T.C. 206, 250 (1979), nonacq., 1980-2 C.B. 2.

[51] *Estate of Israel v. Commissioner*, 108 T.C. 208, 217 (1997).

[52] The scope of section 1256 is discussed in detail below.

[53] Sec. 1223(7); see also Treas. Reg. sec. 1.1223-1(h). If the contract is physically settled and section 1256 does apply, then the taxpayer's holding period begins on the delivery date and does not include the prior period during which the taxpayer held the contract. Sec. 1256(c).

[54] Rev. Rul. 69-93, 1969-1 C.B. 139.

[55] *Hoven v. Commissioner*, 56 T.C. 50, 55 (1971); see also *Merrill v. Commissioner*, 40 T.C. 66, 77 (1963).

[56] *Stanley v. United States*, 436 F. Supp. 581, 583 (N.D. Miss. 1977).

[57] Although the statutory text of section 1233 only makes reference to "short sales," the accompanying regulations indicate that section 1233 applies to forward contracts as well. See Treas. Reg. sec. 1.1233-1(c)(6) (example 6); see also *Hoover Co. v. Commissioner*, 72 T.C. 206, 249 (1979) (applying section 1233 to certain forward contracts).

[58] Sec. 1233(a)-(b).

the underlying asset and immediately delivering it to fulfill its contractual obligations, any capital gain or loss to the short party is short term capital gain or loss.[59]

Forwards for the sale of a single security or a narrow-based security index[60] are subject to a separate regime for under section 1234B. Gain or loss attributable to the sale, exchange, or termination of a securities futures contract is considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the taxpayer's hands. Section 1234B also provides that gain or loss on a securities futures contract, if capital, is treated as short term capital gain or loss regardless of the taxpayer's holding period.

Swaps and notional principal contracts

"Notional principal contract" is the term in the tax law closest to what is colloquially known as "swap." The tax term covers a narrower range of contracts than the colloquial term.[61] Treasury regulations define a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[62] A specified index is defined as a fixed rate, price, or amount that must be based on objective financial information not in control of either party. A notional principal amount is defined as a specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties. For example, if two parties enter a swap in which one party will pay the other $1 million times the one-year London Interbank Offered Rate ("LIBOR") in exchange for fixed periodic premiums, the one-year LIBOR rate is the specified index and $1 million is the notional principal amount.

Examples of notional principal contracts include interest rate swaps, currency swaps, and equity swaps.[63] Treasury regulations exclude certain instruments from the definition of notional principal contract including: (1) section 1256 contracts, (2) futures contracts, (3) forwards, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.

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[59] General Counsel Memorandum 39304, November 5, 1984.

[60] The term "narrow-based security index" includes indexes with nine or fewer component securities, indexes that are heavily weighted toward a small number of component securities, or indexes weighted toward securities with low trading volumes. 15 U.S.C. sec. 78c(a)(55). An option on a broad-based security index is treated as a nonequity option and is subject to section 1256.

[61] An example of a contract that is encompassed within the term "swap" is a bullet swap, which is a single-payment swap; whether it constitutes a notional principal contract under current law is uncertain. For a discussion of proposed regulations addressing bullet swaps, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, fn. 134.

[62] Treas. Reg. sec. 1.446-3(c)(1)(i).

[63] Treas. Reg. sec. 1.446-3(c)(1)(i).

For purposes of calculating the inclusion of income or expense flowing from a notional principal contract, the regulations divide payments exchanged by the parties to the contract into: (1) periodic payments (made at least annually); (2) termination payments (made at the end of the contract's life); and (3) nonperiodic payments (neither (1) nor (2)).[64] Taxpayers must recognize periodic and nonperiodic payments using a specified accrual method for the taxable year to which the payment relates, and must recognize a termination payment in the year the notional principal contract is extinguished, assigned, or terminated.[65] A swap with a significant[66] nonperiodic payment is treated as two transactions: an on-market level payment swap and a loan.[67] The loan must be accounted for independently of the swap. Under 2004 proposed regulations, contingent nonperiodic payments (such as a single payment at termination tied to the change in value of the underlying) are accrued over the life of the swap based on an estimate of the amount of the payment.[68] The amount of a taxpayer's accrual is redetermined periodically as more information becomes available.[69]

Final Treasury regulations do not address the character of notional principal contract payments. However, 2004 proposed Treasury regulations under section 1234A provide that any periodic or nonperiodic payment generally constitutes ordinary income or expense.[70] The preamble to the 2004 proposed regulations explains that ordinary income treatment is warranted because neither periodic nor nonperiodic payments involve the sale or exchange of a capital asset. The 2004 proposed regulations provide that gain or loss attributable to the termination of a notional principal contract is capital if the contract is a capital asset of the taxpayer. The 2004 proposed regulations do not specify whether a taxpayer who holds a notional principal contract for more than one year should recognize capital gain or loss on account of a termination payment as short term or long term, but they do provide that final settlement payments with respect to a notional principal contract are not termination payments under section 1234A.[71]

Short sales

A short sale is a transaction in which one party (the short seller) borrows property from another party (the lender) in exchange for a fee plus a promise to return the property to the lender

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[64] Treas. Reg. sec. 1.446-3(e), (f) and (h).

[65] *Ibid*.

[66] A term defined only indirectly through examples that leave a large area of uncertainty as to what constitutes a "significant" nonperiodic payment.

[67] See Treas. Reg. sec. 1.446-3(g)(6), example 3.

[68] Notional Principal Contracts; Contingent Nonperiodic Payments: Notice of Proposed Rulemaking, Fed. Reg. vol. 69, 38, February 26, 2004, p. 8886 ("2004 proposed regulations").

[69] *Ibid*.

[70] Prop. Treas. Reg. sec. 1.1234A-1.

[71] Prop. Treas. Reg. sec. 1.1234A-1(b).

at a specified future date. When the lender transfers the property to the short seller, the short seller generally sells the property and repurchases the property on or before the date on which the short seller must return the property to the lender. Under section 1233, a short seller's gain or loss from the short sale of property is considered capital gain or loss if the property used to close the short sale constitutes a capital asset in its hands.[72] The short seller's holding period generally starts when the short seller reacquires the property to cover the short and ends when the short seller redelivers the borrowed property to the lender.[73] Thus, short sellers generally recognize capital gain or loss as short term gain or loss.[74]

In a short sale involving securities, the lender does not recognize gain or loss upon transferring the securities to the short seller – nor does the lender recognize gain or loss when the short seller returns the securities to the lender – as long as the transaction meets the requirements of section 1058. To satisfy section 1058, the short sale agreement must (1) provide for the return to the lender of securities identical to those transferred, (2) require that the short seller make payments to the lender equivalent to all interests, dividends, and other distributions to which the lender would have been entitled if the lender had retained ownership and possession of the securities ("in-lieu-of payments"), and (3) not reduce the lender's risk of loss or opportunity for gain with respect to the transferred securities.[75] In-lieu-of payments and borrowing fees paid by the short seller to the lender are generally deductible from the short seller's ordinary income[76] and included as ordinary income to the lender.[77]

Section 1256 contracts

Section 1256 provides timing and character rules for defined types of derivatives, most of which are traded on a U.S. exchange. Any section 1256 contract held by a taxpayer at the close of a taxable year is marked to market, that is, the contract is treated as having been sold by the taxpayer for its fair market value on the last business day of the taxable year.[78] The character of gain or loss is determined under the 60/40 rule: 60 percent of the taxpayer's gain or loss is

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[72] Sec. 1233(a). Special rules apply with respect to stocks, other securities, and commodity futures if the security or future is a capital asset in the hands of the short-selling taxpayer and, as of the date of the short sale, the taxpayer has held property substantially identical to the property borrowed and sold in the short sale transaction. If, on the date of the short sale, the taxpayer has held substantially identical property for more than one year, then any loss on the closing of the short sale is considered a long term capital loss. Sec. 1233(d); Treas. Reg. sec. 1.1233-1(c).

[73] Treas. Reg. sec. 1.1233-1(a)(3)-(4).

[74] Michael R. Powers, David M. Schizer and Martin Shubik, "Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales," *Tax Law Review*, vol. 57, 2004, pp. 233-74.

[75] Sec. 1058(b).

[76] Rev. Rul. 72-521, 1972-2 C.B. 178.

[77] Prop. Treas. Reg. sec. 1.1058-1(d).

[78] Sec. 1256(a)(1).

treated as long term capital gain or loss, and the remaining 40 percent of the taxpayer's gain or loss is treated as short term capital gain or loss, regardless of the taxpayer's holding period.[79] The 60/40 rule also applies if the contract is terminated or transferred during the taxable year.[80]

A section 1256 contract is defined as: (1) a regulated futures contract,[81] (2) a foreign currency contract,[82] (3) a nonequity option traded on or subject to the rules of a qualified board or exchange,[83] (4) an equity option purchased or granted by an options dealer that are listed on a qualified board or exchange on which the dealer is registered,[84] and (5) a securities futures contracts entered into by a dealer that are traded on a qualified board or exchange. Excluded from the definition of section 1256 contracts are (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract and (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[85]

Mark to market accounting for dealers and traders

While section 1256 imposes mark to market for particular classes of contracts, section 475 imposes mark to market on a particular class of taxpayers. Section 475 requires that securities dealers – taxpayers that regularly purchase securities from or sell securities to customers in the ordinary course of business – recognize gain and loss on a mark to market basis. The term "security" is defined to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments and other positions identified as hedges with respect to any of the above-mentioned instruments.[86] The statute also allows traders in securities to elect into mark to market, and it

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[79] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that, but for the rule in section 1256(a)(3), would be ordinary income property.

[80] Sec. 1256(c)(1).

[81] A contract is a "regulated futures contract" if the parties are required to post margin on a mark to market basis and the contract is traded on or subject to the rules of a qualified board or exchange. Sec. 1256(g)(1).

[82] The interaction between section 988 governing foreign currency transactions and section 1256 is extremely complex, *see* Viva Hammer, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," *Bulletin of International Taxation,* vol. 64, no. 3, March 2010, expanded and updated in Practising Law Institute, *Taxation of Financial Products and Transactions,* Matthew A. Stevens (ed.), 2013.

[83] An option on a narrow-based security index is treated as an equity option and therefore not a section 1256 contract.

[84] Sec. 1256(g)(4).

[85] Sec. 1256(b)(2).

[86] Sec. 475(c)(2).

allows traders in commodities to opt into the mark to market regime and to have their commodity holdings treated analogously to securities under section 475.[87]

For taxpayers required to follow the mark to market rules or who elect into those rules, securities or commodities in the hands of the taxpayer at the close of a tax year must be treated as if they were sold for their fair market value on the last business day of the year. All resulting mark to market gains or losses with respect to such securities or commodities are treated as ordinary.[88] However, mark to market accounting is neither required nor permitted: (1) for securities held for investment; (2) for debt instruments acquired in the ordinary course of trade or business (unless those debt instruments are held for sale, in which case they must be marked to market); and (3) for securities that are held as hedges (unless the security is a hedge for another security that is inventory in the hands of the dealer, in which case the hedge must be marked to market as well).[89]

Straddles

Section 1092 defines a "straddle" as offsetting positions with respect to actively traded property.[90] Positions are considered "offsetting" if a taxpayer substantially diminishes its risk of loss with respect to one position by holding one or more other positions.[91] Section 1092(a) provides that a taxpayer's loss with respect to one position that is part of a straddle may only be taken into account to the extent that the loss exceeds the taxpayer's unrecognized gain with respect to any offsetting position that is part of the straddle. The taxpayer may carry forward any disallowed loss into succeeding taxable years and may take that loss into account once the taxpayer disposes of the offsetting position.[92]

Exceptions from the straddle rules are provided for hedging transactions,[93] straddles composed entirely of section 1256 contracts,[94] and qualified covered calls.[95] Special rules apply

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[87] Sec. 475(f).

[88] Sec. 475(d)(3).

[89] Sec. 475(b)(1).

[90] Sec. 1092(c)(1) and (d)(1).

[91] Sec. 1092(c)(2)(A).

[92] Sec. 1092(a)(1).

[93] Sec. 1092(e). A hedging transaction is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property held by the taxpayer or to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or ordinary obligations incurred by the taxpayer. Sec. 1221(b)(2)(A). To qualify as a hedging transaction for purposes of the straddle rule exception, the transaction must be clearly identified as such before the close of the day on which the transaction was entered into. Sec. 1256(e)(2).

[94] Sec. 1256(a)(4).

for mixed straddles (generally, straddles comprised of both section 1256 contracts and non-section 1256 contracts)[96] and for identified straddles.[97]

Conversion transactions

Section 1258 prevents taxpayers from transforming ordinary interest income into capital gain through "conversion transactions." A conversion transaction is one in which substantially all of the taxpayer's expected return is attributable to the time value of the taxpayer's net investment in the transaction. Section 1258 reclassifies some or all of the taxpayer's gain as ordinary income. The taxpayer must calculate an "applicable imputed income amount," which is equal to the amount of interest which would have accrued on the taxpayer's net investment in the conversion transaction at an interest rate equal to 120 percent of the applicable federal rate.[98] Such gain that does not exceed the applicable imputed income amount is treated as ordinary income. However, unlike the rules for original issue discount debt instruments (which require the current inclusion of imputed interest income), section 1258 allows the taxpayer to defer taxation on imputed income until the disposition or termination of a position held as part of a conversion transaction.[99]

Constructive sales

Section 1259 requires taxpayers to recognize gain upon entering into a "constructive sale."[100] In a constructive sale, a taxpayer that holds stock, debt instruments, or partnership interests with unrealized gains (1) enters into a short sale of the same or substantially identical property, (2) enters into an offsetting notional principal contract with respect to the same or

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[95] Sec. 1092(c)(4). To fit within the exemption for qualified covered calls, an option (1) must be exchange-traded, (2) must be granted more than 30 days (but no more than 33 months) before it expires, (3) must not be a "deep-in-the-money" option, and (4) must not be granted by an options dealer in connection with its option dealing activity. Moreover, an option is not a qualified covered call option if gain or loss with respect to the option is ordinary income or loss. Sec. 1092(c)(4); Treas. Reg. sec. 1.1092(c)1(b).

[96] Sec. 1092(b)(2). If a straddle consists of positions that are section 1256 contracts and non-section 1256 contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark to market rule of section 1256, but instead are subject to regulations designed to prevent the deferral of tax or the conversion of short term capital gain into long term capital gain or the conversion of long term capital loss into short term capital loss.

[97] Sec. 1092(a)(2). If a taxpayer clearly identifies a straddle as such before the close of the day on which the straddle is acquired, then the loss deferral rules of section 1092(a) do not apply. Instead, any loss incurred with respect to a position that is part of an identified straddle will be added to the tax basis of the offsetting positions in the straddle. Sec. 1092(a)(2)(A); William R. Pomierski, "Identified Straddles: Uncertainties Resolved and Created by 2007 Technical Corrections," *Journal of Taxation of Financial Products*, vol. 7, no. 2, 2008, pp. 5-10, 55-57.

[98] The applicable federal rate is the rate determined under section 1274(d) (compounded semiannually) as if the conversion transaction were a debt instrument.

[99] Compare sec. 1258(a) with sec. 1272(a).

[100] Sec. 1259(a).

substantially identical property, or (3) enters into a futures or forward contract to deliver the same or substantially identical property.[101] However, the section 1259 rules do not apply to depreciated financial positions. Thus, a taxpayer that engages in a short sale against the box or other constructive sale cannot claim a capital loss as a result of the transaction.[102]

Constructive ownership transactions

Section 1260 classifies certain derivatives transactions as "constructive ownership transactions" and treats a portion of the gain on such transactions as ordinary income. Section 1260 applies to taxpayers that use derivatives to take positions with respect to "financial assets."[103] A financial asset is any equity interest in a passthrough entity such as a regulated investment company, a real estate investment trust, an S corporation, a partnership, a trust, a common trust fund, a passive foreign investment company, or a real estate mortgage investment conduit.[104]

Under section 1260, a taxpayer that constructively owns an equity interest in a passthrough entity must calculate its "net underlying long term capital gain" with respect to the asset. The net underlying long term capital gain is the aggregate long term capital gain that the taxpayer would have recognized if the taxpayer had purchased the equity interest outright for its fair market value on the date of the constructive ownership transaction and had sold the equity interest for its fair market value on the date that the constructive ownership transaction was closed.[105] Any gain on the constructive ownership transaction in excess of the net underlying long term capital gain is treated as ordinary income.[106] Section 1260 also imposes an interest charge on the gain in excess of the net underlying long term capital gain in order to compensate the government for the

[101] Sec. 1259(c)(1)(A)-(C). The definition of "constructive sale" also encompasses transactions in which a taxpayer who has previously entered into a short sale of stock, debt instruments, or partnership interests subsequently acquires property that is the same or substantially identical to the short-sold property. Sec. 1259(c)(1)(D).

[102] Rev. Rul. 2002-44, 2002-28 I.R.B. 84.

[103] Sec. 1260(d)(1). An options transaction is classified as a constructive ownership transaction if a taxpayer is the both holder of a call option and the grantor of a put option with respect to a financial asset and the two options have substantially equal strike prices and substantially contemporaneous maturity dates. Sec. 1260(d)(1)(C).

[104] Sec. 1260(c)(1)(A), (c)(2). The statute also authorizes the Treasury Secretary to promulgate regulations classifying debt instruments or stock in C corporations as "financial assets" for purposes of the constructive ownership rules. Sec. 1260(c)(1)(B). However, the Secretary has yet to exercise this regulatory authority.

[105] Sec. 1260(e).

[106] Sec. 1260(a)(1).

fact that the taxpayer has deferred taxation on ordinary income over the life of the constructive ownership transaction.[107]

Identification of hedges

Several provisions governing the taxation of derivatives grant special treatment to "identified" hedges. The mark to market requirement under section 475 does not apply to any security which is identified as a hedge with respect to a position, right, or liability that is not itself subject to the mark to market rule.[108] Likewise, the mark to market requirement under section 1256 does not apply to a transaction that the taxpayer identifies as a hedging transaction.[109] The straddle rules of section 1092 do not apply to identified hedges.[110]

Treasury regulations prescribe the manner of identification for hedging transactions.[111] The identification generally must be made by the close of the day on which a taxpayer entered into the hedging transaction.[112] The identification must be made on, and retained as part of, the taxpayer's books and records.[113] The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes.[114]

Example of inconsistency under current law

An example of an instrument that creates opportunities for taxpayers as a result of uncertainties and inconsistencies in current law is the exchange traded note. [115] An exchange-traded note is a debt-like instrument the value of which is linked to a specified market index.

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[107] Sec. 1260(b). The statute treats the taxpayer as if she had underpaid taxes in each year that the constructive ownership transaction was open. The amount of the underpayment is equal to the amount that the taxpayer would have paid in ordinary income tax if the amount in excess of net underlying long term capital gain had accrued at a constant rate equal to the applicable federal rate in effect on the day the transaction closed. Sec. 1260(b)(1)-(3).

[108] Sec. 475(b)(1)(C), (2).

[109] Sec. 1256(e).

[110] Sec. 1092(e).

[111] Regulations accompanying sections 475, 1092, and 1256 generally incorporate the identification requirements set forth in Treas. Reg. sec. 1.221-2(f). See Treas. Reg. sec. 1.475(b)-1(d)(2); Treas. Reg. sec. 1.1256(e)-1(b); see also Treas. Reg. sec. 1.1092(b)-5T(b) (cross-referencing the section 1256(e) requirements).

[112] Treas. Reg. sec. 1.1221-2(f)(1).

[113] Treas. Reg. sec. 1.1221-2(f)(4)(i).

[114] Treas. Reg. sec. 1.1221-2(f)(4)(ii).

[115] Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, pp. 86-90.

The purchaser of an exchange-traded note makes an upfront payment to a financial institution. In return, the financial institution promises that, upon maturity, it will pay the holder of the note an amount equal to the principal amount times an "applicable index factor" (calculated on the basis of, *e.g.*, the performance of the S&P 500 over the life of the note).

Issuers and holders of exchange-traded notes typically treat the notes as prepaid forward contracts for tax purposes, and holders obtain significant tax deferral compared to purchasing the underlying directly. For example, an investor who holds a portfolio of securities reflecting the S&P 500 will pay tax on dividend income annually and may face capital gains tax when corporations whose shares are included in the index are acquired in a taxable transaction. If exchange-traded notes are treated as forward contracts, then an investor who holds an exchange-traded note to maturity can defer all potential tax consequences until the issuer redeems the note. Taxpayers may also use exchange-traded notes to alter the character of investment income: gain on an exchange-traded note linked to a fixed-income index may be eligible for the preferential long term capital gains rate, whereas an investor who holds fixed-income assets directly must pay tax on interest income at ordinary rates.

In 2008, the IRS issued a ruling holding that an exchange-traded note is treated as debt for Federal tax purposes where the value of the note at maturity is determined exclusively by reference to (1) the U.S. dollar-euro exchange rate and (2) euro interest rates.[116] In the ruling, the IRS applied section 988, which governs foreign currency transactions. The IRS simultaneously issued a request for comments regarding timing, character, source, and other issues respecting exchange-traded notes and similar contracts.[117] The IRS has not issued definitive guidance regarding exchange-traded notes and similar contracts that are not directly addressed by the 2008 revenue ruling.

Description of Proposal

The proposal requires all taxpayers to mark their "derivative contracts" to market, that is, to recognize gain or loss from their derivative contracts as if the contracts were sold for fair market value on the last business day of the taxpayers' taxable year. Gain and loss from the mark to market is treated as ordinary income or loss attributable to a trade or business of the taxpayer. The proposal defines derivative contract to include any contract the value of which is determined, directly or indirectly, by the value of actively traded property. The proposal also requires derivative contracts embedded in other financial instruments, such as contingent payment debt instruments or structured notes linked to actively traded property, to be marked to market.[118] The proposal does not require other types of "financial instruments," such as stocks and bonds, to be marked to market. However, if a taxpayer enters into a "straddle transaction"

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[116] Rev. Rul. 2008-1, 2008-2 I.R.B. 248.

[117] Notice 2008-2, 2008-2 I.R.B. 252.

[118] One common example of derivative embedded in another financial instrument is a convertible bond, which can be viewed as a bond with an "embedded" option to purchase equity in the issuer. It is not clear whether the proposal is intended to apply to bonds that are convertible into the issuer's own stock.

comprising a derivative contract and another financial instrument, then the non-derivative is also required to be marked to market. Upon entering into such a straddle, the taxpayer must recognize any built-in gain (but may not recognize built-in loss) on the non-derivative part of the straddle.

Derivatives that are "business hedging" transactions are excepted from mark to market "accounting" under the proposal. A derivative contract qualifies as a business hedging transaction if the taxpayer enters into the contract in the ordinary course of its trade or business primarily to manage the risk of price changes (including interest rate changes, currency fluctuations, and credit deterioration) with respect to ordinary property or ordinary obligations, provided that the taxpayer specifically identifies the derivative contract as a hedging transaction before the close of the day on which the taxpayer enters into the contract. Under the proposal, a taxpayer satisfies the identification requirement if the taxpayer identifies the transaction as a business hedge for financial accounting purposes.

The proposal eliminates sections 1256 and 1092. The proposal "significantly curtails" the application of section 1233 short sale rules, section 1234 option rules, section 1234A rules on gains and losses from certain terminations, section 1258 conversion transaction rules, section 1259 constructive sale rules, and section 1260 constructive ownership rules, though details of the curtailment are not provided.

Effective date.−The proposal applies to derivative contracts entered into after December 31, 2013.

Analysis

Present law leads to inconsistencies, complexities and uncertainties in the tax treatment of derivatives. The proposal seeks to provide a uniform treatment for derivatives by requiring a single rule for recognition of income (mark to market) and a single rule for the character of that income (ordinary). No new rule is proposed for the sourcing of flows from derivatives.

For example, as discussed above, the exchange-traded note creates opportunities for taxpayers that result from uncertainties and inconsistencies under present law. Exchange-traded notes are usually issued by financial institutions that are dealers under section 475 and marking the contracts to market.[119] As derivative contracts are linked to actively traded property, exchange-traded notes are subject to the proposal's mark to market requirement for holders also, and all gain or loss from the notes is ordinary. If the holder is subject to mark to market, then exchange-traded notes provide no deferral advantage and no tax arbitrage opportunity as between holder and issuer. Under the proposal, holders of exchange-traded notes linked to equity indexes may find themselves at a disadvantage relative to investors who hold equity index funds, exchange-traded funds, or individual stocks, since holders of exchange-traded notes will not be

[119] Ray Beeman and Yoram Keinan, "The Tax Treatment of Exchange-Traded Notes: Here We Go Again," *Tax Notes*, May 5, 2008, pp. 485-98.

eligible for preferential tax rates on long term capital gains and dividends on the underlying securities.[120]

More generally, as discussed below, the proposal attempts to standardize the tax treatment of economically equivalent transactions, provide character certainty for flows of income, and standardize the treatment of gain and loss upon termination of a transaction.

Standardizing the categorization of economically equivalent transactions

Under present law, the tax treatment of a derivative depends largely on the form of the transaction: whether it is classified as an option, a forward, futures contract, a notional principal contract, or something else. The delineation of these forms is sometimes rigid (for example, definition of notional principal contract), and sometimes uncertain (for example, there is no uniform definition of a forward). Because of the ad hoc manner in which the rules for financial transactions developed, the current collection of statute, regulations, IRS guidance, and case law together fails to coherently govern or encompass the universe of derivatives. Because derivatives are more flexible in design than transactions directly involving the underlyings, a tax system focused on the form of the transaction has proven inadequate.

An example of a transaction with multiple possible tax characterizations is the credit default swap ("CDS"), in which a "protection buyer" agrees to make premium payments to a "protection seller" in exchange for the seller's promise to make a "settlement payment" to the buyer in the event that a "reference entity" (*e.g.*, a corporation, a sovereign entity, a State or municipality, etc.) experiences a defined credit event. The settlement could involve a monetary payment or the delivery of referenced debt instrument(s). Controversy over the taxation of CDS was unresolved by Congress or Treasury throughout the period of its rapid growth. Practitioners suggested a number of tax characterizations, including treating CDS as insurance, a guarantee, an option, a notional principal contract, or some unclassified financial instrument. The tax consequences of these various characterizations can be significantly different, and because of the lack of guidance, taxpayers (or the IRS) could take their pick of outcomes.[121] Proposed Treasury regulations adopt the position that the transactions are notional principal contracts.[122]

The proposal prescribes uniform treatment for all derivative transactions linked to actively traded property, irrespective of the form of the contract, eliminating the current tax arbitrage opportunities arising from the different tax treatment of different forms of derivative. However, the proposal does not apply to derivatives with non-actively traded underlyings, preserving the pitfalls of the current system for these transactions.

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[120] Under the proposal, equity index funds and exchange-traded funds would not be treated as derivatives.

[121] See, for example, Bruce Kayle, "Will the Real Lender Please Stand Up: The Federal Income Tax Treatment of Credit Derivative Transactions," *Tax Lawyer*, vol. 50, no. 3, 1997, pp. 569-616; Kevin J. Liss, "Are Credit Default Swaps Really Swaps or Options for Tax Purposes? An Economics-Based Approach," *Journal of Taxation of Financial Products*, vol. 7, no. 1, 2008, p. 23.

[122] Prop. Treas. Reg. sec. 1.446-3(c)(iii).

Providing character certainty for flows from derivatives

Current law has no comprehensive schema for determining the character of flows from derivatives as ordinary or capital. For CDS, for example, even if taxpayers determine the transaction fits within the definition of notional principal contract rather than other possible characterizations, the treatment of settlement payments is uncertain. Some treat them as termination payments that are capital in character, while others have suggested that they are nonperiodic payments that give rise to ordinary income and expense.[123] If there is a gain, individuals may have an incentive to characterize settlement payments as termination payments giving rise to capital gain (which may be eligible for the preferential tax rate on long term capital gain), while if there is a loss, both corporations and individuals may have an incentive to characterize settlement payments as nonperiodic payments giving rise to ordinary expense. If the underlying is actively traded, the proposal eliminates the possibility for inconsistent treatment because all gains or losses on transactions covered by the proposal are ordinary.[124]

Standardizing the treatment of gain or loss upon termination of a transaction

Present law leads to differing character of gain or loss on final payments from derivatives depending on the way in which parties terminate their transactions, even if the economics underlying the termination methods are the same. Take the example of an interest rate swap entered into by an entity taxed as a passthrough such as a partnership so that its tax effect flows through to an individual. Under the terms of the swap, the entity agrees to pay $1 million multiplied by the one-year LIBOR rate at annual intervals over a two-year term and the counterparty agrees to pay $1 million multiplied by a two percent fixed rate at annual intervals over the two-year term, the entity must recognize contractual payments in ratable daily portions as ordinary income or loss in the year in which they occur.[125] However, if after one year the LIBOR rate has fallen such that the entity holds a gain position, the entity may sell its position and the resulting gain is long term capital gain eligible for the preferential rate. Meanwhile, if after one year the LIBOR rate has risen such that the entity holds a loss position, the entity may pay out under the swap as originally intended and the resulting losses are recognized over the life of the contract as ordinary in character. In effect, present law may allow individuals to recognize gain on a derivative as long term capital gain while recognizing loss on the same transaction as ordinary loss. The proposal eliminates this character arbitrage because it requires taxpayers to treat all gain or loss on covered derivatives transactions, including gain or loss attributable to the sale or termination of a derivatives contract, as ordinary in character.

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[123] Erika W. Nijenhuis, "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives," *Columbia Journal of Tax Law*, vol. 2, 2011, pp. 1-99; New York State Bar Association Tax Section, *Report on Credit Default Swaps*, September 9, 2005, p. 62.

[124] This discussion assumes that the proposal provides that all gain and loss on derivatives is ordinary, whether resulting from mark to market or otherwise.

[125] Treas. Reg. sec. 1.446-3(e).

Issues and questions

Definition of derivative contract

While the proposal eliminates much of the uncertainty caused by current law, it also introduces new uncertainties because of the general nature of the definition of "derivative contract." Some transactions are potentially within the definition that might not be intended to be covered by it. For instance, if a homeowner obtains an adjustable-rate home equity loan from a bank, does that transaction become a "derivative contract"? The definition of derivative would need to be clarified.

Actively traded property

The proposal only applies to derivatives with respect to "actively traded property." Although the proposal does not define that term, it may have intended to incorporate the definition of the same term used in section 1092.[126] That code section was enacted to prevent tax avoidance using straddles consisting of highly liquid derivatives and securities ("actively traded property") to avoid recognition of income and make conversions between ordinary income and capital gain or loss.

Section 1092 regulations provide that actively traded property is property for which there is an established financial market. The term "established financial market" includes a national securities exchange, an interdealer quotation system sponsored by a national securities association, a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission, a foreign securities exchange or board of trade that satisfies analogous regulatory requirements, an interbank market, an interdealer market,[127] and a debt market.[128]

Regulations refining the definition of "actively traded" property have been promulgated from time to time to clarify section 1092. The advantage of using "actively traded property" as the underlying for the proposal is that such underlyings are more likely to have publicly available values associated with them, making the derivatives subject to the proposal easier to value as well. This concept from the straddle rules may not fit the purpose of the proposal. New rules focused on appropriately taxing derivative markets rather than to prevent straddles may be needed. One problem to be addressed is when underlyings fluctuate between being actively traded and non-actively traded during a single taxable year. This is not uncommon for rising or dying markets, or for currencies that are sensitive to international economic and national political

[126] Treas. Reg. sec. 1.1092(d)-1.

[127] An interdealer market, in turn, is a system of general circulation that provides a reasonable basis to determine the fair market value of property based on recent price quotations or actual prices of recent transactions. Treas. Reg. sec. 1.1092(d)-1(b)(2)(i).

[128] In general, a debt market exists if price quotations are readily available from brokers, dealers, or traders (although the relevant regulation sets out several exceptions to this general rule). Treas. Reg. sec. 1.1092(d)-1(b)(2)(ii).

changes.[129] In addition, the proposal would need rules for the case in which a single derivative references both actively traded and non-actively traded property.

Derivatives linked to the value of investment partnerships (*e.g.*, hedge funds and private equity funds) may not be subject to the mark to market requirement because limited partnership interests in those funds may not be actively traded. It should be clarified whether this is the intent of the proposal.

Embedded derivatives

If a derivative is "embedded" within another "financial instrument," the derivative is required to be marked to market under the proposal if the derivative "by itself" would be marked to market. Three critical terms are undefined, "financial instrument," "embedded," and "by itself." The term "embedded" has been defined under generally accepted accounting principles[130] although there is no reference to those principles in the proposal.

Should the derivatives in convertible bonds (*i.e.*, bonds that give their holders an embedded call option on the issuer's stock) or shares of convertible preferred stock (*i.e.*, shares of preferred stock that give their holders an embedded call option on the issuer's common stock) qualify as embedded derivatives under the proposal? Should the answer be different for callable bonds (*i.e.*, bonds that give the issuer an embedded call option to repurchase the bond), putable bonds (*i.e.*, bonds that give the holder an embedded put option to sell the bond back to the issuer), or extendible bonds (*i.e.*, bonds that give the issuer an embedded put option to sell new bonds to the holder when the first bond matures)? Clarification is needed for these and other common types of instruments.

In many cases, an embedded derivative would never be found "by itself" in the marketplace and so developing valuation methods for such derivatives may require special rules.

Inconsistencies in the treatment of derivative and non-derivative transactions

The proposal does not affect the treatment of non-derivative instruments such as stocks and bonds and leaves in place the historical divide between ordinary and capital income, the preferential tax rate for long term capital gain and the realization-based timing rules for non-derivative financial instruments. As long as these features of the tax code remain in place, tax arbitrage opportunities remain because the new divide between non-derivative and derivative financial instruments may present new opportunities for arbitrage.

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[129] In an analogous example from the Asian financial crisis in 1997, the Thai baht collapsed followed by collapse in the Indonesian and South Korean currencies. Trading of derivatives on these currencies on U.S. exchanges was destabilized, causing uncertainty in the status of derivatives on the currencies for section 1256(g)(2) purposes.

[130] ASC 815-15-25-1-Derivatives and Hedging.

Source of income

The proposal makes no changes to the rules regarding the source of income from derivatives transactions. Most recently, Congress has responded to concerns about withholding tax by enacting section 871(m) which provides U.S. source treatment of certain dividend-equivalent amounts. Concerns about source rules are not addressed by the proposal.

Liquidity and tax burden

One general criticism of a mark to market requirement is that taxpayers may have tax on gains when they do not have sufficient liquid assets to pay the tax.[131] Similar concerns were voiced prior to the enactment of the original issue discount rules in 1969,[132] although those rules have been complied with successfully for over 40 years. Moreover, the existing tax regime for options and forwards already creates mismatches between cash flows and tax liabilities: both options and prepaid forwards require cash outlays by one party without immediate tax deductions. In addition, one party to a notional principal contract with significant upfront nonperiodic payments must include those payments in income over the life of the swap.

Mark to market taxation frees taxpayers' losses without any transaction costs, and for taxpayers with a portfolio of derivatives the benefit of freed losses will mitigate tax on the unrealized gains. Although taxpayers may expect more gains than losses, in a derivatives contract the payments between the parties is a zero sum game and so the issue of liquidity to pay for unrealized gains may be more one of perception than reality.

In addition, under the current financial regulatory regime, far more derivatives than before are traded on markets requiring the posting of margin so that actual cash changes hands to reflect the change in value of a taxpayer's derivative, eliminating the problem of liquidity to pay tax.[133] In addition, the Standard Credit Support Annex to the ISDA Master Agreement, which is widely used with respect to non-cleared over-the-counter swaps, incorporates variation margin requirements that are essentially identical to those imposed by central clearing parties.[134]

Under current law, individuals who engage in derivatives transactions – as well as individuals with interests in partnerships and other passthrough entities that engage in derivatives transactions – may be eligible for the preferential tax rate on long term capital gains with respect

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[131] See, for example, Edward A. Zelinsky, "For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues," *Cardozo Law Review*, vol. 19, no. 3, December 1997, pp. 861-961.

[132] William B. Landis, "Original Issue Discount After the Tax Reform Act of 1969," *Tax Lawyer*, vol. 24, no. 3, 1971, pp. 435, 452.

[133] Anupam Chander and Randall Costa, "Clearing Credit Default Swaps: A Case Study in Global Legal Convergence," *Chicago Journal of International Law*, vol. 10, no. 2, 2010, pp. 639-683.

[134] International Swaps and Derivatives Association, *ISDA Margin Survey 2013*, June 2013, p. 8.

certain derivative-related income.[135] Meanwhile, capital losses on derivatives transactions (for individuals as well as for corporations) are subject to capital loss limitations, while ordinary losses on derivatives transactions that are not related to an individual taxpayer's trade or business may be subject to the two percent floor on miscellaneous itemized deductions under section 67 and the overall limitation on itemized deductions under section 68 and may be disallowed for purposes of computing the taxpayer's alternative minimum taxable income.[136] The proposal treats all gains and losses on derivatives linked to actively traded property as ordinary income attributable to a trade or business of the taxpayer.

Although the proposal increases the tax rate on derivatives-related gains (by treating these gains as ordinary income rather than long term capital gains taxpayers could respond to the rate increase by "scaling up" their derivatives positions. Economists have argued that as long as losses can be used to offset gains and taxpayers can adjust the size of their risky bets costlessly, then the statutory tax rate on risk-based returns should have no net effect on taxpayers' after-tax returns (provided that the tax rate is less than 100 percent).[137] This is arguably most applicable with respect to cash settled forwards and swaps. Taxpayers can adjust to higher statutory rates by increasing the specified quantity under the forward contract or by increasing the notional amount of the swap.[138]

The proposal makes it easier for individuals to use losses from derivatives to offset unrelated income, since these losses will no longer be subject to capital loss limitations or to limitations on itemized deductions.

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[135] As noted above, gain from the exercise of a cash settled option is treated as long term capital gain if the taxpayer has held the option for more than one year; gain from the settlement of a forward contract may be long term capital gain under certain circumstances; gain from the sale or exchange of a derivative contract held for more than one year may qualify as long term capital gain under section 1234A; and 60 percent of all gain from section 1256 contracts is long term capital gain.

[136] Secs. 56(b)(1)(A)(i), 67, 68; see also McGrath, "Using Derivatives to Enhance After-Tax Hedge Fund Returns," pp. 491-93; Schizer, "Balance in the Taxation of Derivative Securities," pp. 1937-38, n.180.

[137] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk-Taking," *Quarterly Journal of Economics*, vol. 58, no. 3, May 1944, pp. 388-422; Schizer, "Balance in the Taxation of Derivative Securities," pp. 1891, 1897-1901. The Domar-Musgrave result hinges upon several significant conditions and limitations: (1) the result only applies to risk-based returns and not risk-free returns arising from the time value of money; (2) the result only applies when a taxpayer's losses can be fully used to offset the taxpayer's gains; and (3) the result relies on the assumption that the supply of risky assets is unlimited and that bets can be scaled up costlessly. Joseph Bankman and Thomas Griffith, "Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?", *Tax Law Review*, vol. 47, no. 2, Winter 1992, pp. 377-406. The Domar-Musgrave result does not apply to investments in stocks and bonds, where (1) a portion of the return on investment represents the time value of money; (2) taxpayers are subject to capital loss limitations and cannot necessarily use their losses to offset gains; and (3) the supply of stocks and bonds is not infinite.

[138] Schizer, "Balance in the Taxation of Derivative Securities," pp. 1901-07.

Valuation

The proposed rule requires taxpayers to treat derivatives as if they were sold at the end of the tax year and recognize gain or loss. Without an actual sales price, taxpayers and the IRS will have to devise methods for finding fictional "as if sold" sales prices. If the type of derivative subject to mark to market is heavily traded, finding an "as if sold" sale price is straightforward. If the derivative is less liquid, and actual evidence is lacking, taxpayers and the IRS will have to agree on a theoretical value. This could involve developing algorithms, obtaining appraisals from experts, or other methods. Any of these methods may be costly, inaccurate, or both.

Valuation is not a new problem; taxpayers claimed valuation issues would make section 475 impossible to comply with. Nevertheless, section 475 has been complied with by taxpayers and administered by the IRS for 20 years. In addition, many disciplines in the financial world (various forms of accounting, risk management, financial forecasting, compensation) rely on mark to market and the tax profession can learn much from the theory developed in these fields.

Valuation is a lesser concern for derivatives subject to variation margin requirements because of the markets on which they trade: these contracts are already marked to market on a daily basis, so an annual appraisal for tax purposes is unlikely to introduce significant costs. For derivatives linked to actively traded property that are not themselves actively traded (*e.g.*, stock options that do not follow the third-Friday-of-the-month convention), valuation challenges may be more significant. However, these valuation challenges are not unlike those that other taxpayers already face under the status quo (*e.g.*, when taxpayers elect to include unvested stock options in income under section 83(b)). The IRS has addressed challenges of certain options in sections 280G and 4999 (regarding golden parachute payments), adopting a safe harbor for valuations based on the Black-Scholes option pricing method.

The benefit of the mark to market method is that taxpayers must revalue their derivatives every year, and consistent year after year mis-valuation to achieve some tax advantaged goal would be difficult. In addition, the large number of taxpayers using mark to market for other purposes – accounting, regulatory, trader compensation – will reduce their work load regarding derivatives calculations compared to the current regime and the IRS would have the ability to check tax values for mark to market against values reported for those other purposes.

Hedging exception

The proposal includes an exception to mark to market "accounting" for derivatives transactions that qualify as business hedges: those transactions that manage risks related to ordinary property or ordinary obligations and identified as a hedge before the close of the day on which the taxpayer entered into the transaction. It is unclear how this exception interacts with current section 1221 character rule for hedges although perhaps under the proposal derivatives used as hedges will have ordinary character. That is, if a derivative is a business hedge, it no longer has to be marked to market under the proposal but does have ordinary character.

Current hedging regulations under section 1221 provide that the identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy tax identification requirement unless the taxpayer's books and records indicate that the identification

also is being made for tax purposes. The proposal reverses this rule and allows taxpayers to satisfy the tax hedge identification requirement by identifying the transaction as a business hedge for financial accounting purposes only.

The definition of a hedge is different under financial accounting principles and under the tax law because the purpose of the accounting and tax hedging regimes are different. Financial accounting has a general principle of marking all derivatives to market and provides a hedging exception to allow businesses to match income from the item being hedged with the derivative used as a hedge, adjusting recognition of the two income flows accordingly. In contrast, the current tax rules for hedging developed to resolve the controversy over the character of income (particularly losses) flowing from derivatives used as hedges. The current tax hedging regime requires that taxpayers treat income and loss from derivatives used as hedges as ordinary income and loss. In addition, Treasury regulations require that timing of income and loss on a hedge be matched with the timing of income on the item being hedged. Same-day identification of a transaction as a tax hedge ensures that taxpayers do not cherry pick the treatment of their derivatives depending on the transaction's ultimate outcome.

Given the different purposes of the hedging regimes for accounting and tax, it is hard to see how an accounting identification will protect the Government against cherry picking the treatment of hedging transactions. When a taxpayer identifies a transaction as a hedge for financial accounting purposes without any further indication as to whether it is a tax hedge or not, the taxpayer can then wait and see how the transaction performs and then determine whether it will claim the transaction is a tax hedge. Without a penalty regime, such behavior is not discouraged by the proposal and in effect eliminates the identification requirement for transactions that are hedges for both tax and accounting purposes, since it will be impossible for the IRS to determine which transactions are accounting hedges only and which are both accounting and tax hedges.

Providing an exception to mark to market treatment for business hedges raises broader questions about the policy behind the current tax hedging regime, and the opportunity for reconsidering its scope. As mentioned, the primary purpose of the current tax hedging regime is to provide relief from capital losses from derivatives, that is, the hedging rules had a character focus. Under the proposal, all income from derivatives – whether hedges or not – is ordinary in character. Under the proposal, it appears that hedging provides a timing exception only.

Straddles

The proposal eliminates section 1092 governing the current treatment of straddles and at the same time requires mark to market treatment of non-derivative financial instruments that, together with derivatives, constitute straddles. The straddle rule under the proposal raises a number of issues.

If section 1092 is repealed, a new definition of straddle would be needed to implement the proposal's new straddle rule. A reconsideration of the straddle concept is appropriate given the different purposes of the new and old straddle rules. Much of the current straddle apparatus may be irrelevant, because it was enacted as an anti-abuse provision rather than a substantive rule, but lessons from over 25 years of experience are worth considering. For example, under the

current rules, the central term in the definition of straddle has an uncertain meaning, namely "substantial diminution of risk of loss." In addition, the role of the qualified covered call exception is unclear.

The proposal introduces a new concept labeled "financial instrument" that together with a derivative constitutes a straddle. The proposal gives the example of stock as being such an instrument, but presumably other kinds of instruments would be encompassed as well. Would these include assets only or also liabilities of the taxpayer?

There may be a need for some continuing conventional straddle anti-abuse rule if transactions fall outside the technical definition of derivative and therefore outside mark to market treatment and yet could still be used to manipulate timing and character outcomes that caused the straddle regime to be enacted.

PART VII − ELIMINATE FOSSIL FUEL PREFERENCES

A. Repeal Domestic Manufacturing Deduction for Oil and Natural Gas Production

Description of Modification

Like the fiscal year 2013 budget proposal,[139] the fiscal year 2014 budget proposal excludes from the definition of domestic production gross receipts all gross receipts from the sale, exchange, or other disposition of oil, natural gas, or a primary product thereof for taxable years beginning after December 31, 2013. Unlike the fiscal year 2013 budget proposal, this proposal does not use the additional revenue gained from limiting the domestic manufacturing deduction to increase the deduction rate for the manufacture of advanced technology property.[140]

[139] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 88.

[140] *Ibid*. at p. 93.

B. Repeal Domestic Manufacturing Deduction for the Production of Coal and Other Hard Mineral Fossil Fuels

Description of Modification

Like the fiscal year 2013 budget proposal,[141] the fiscal year 2014 budget proposal excludes from the definition of domestic production gross receipts all gross receipts from the sale, exchange, or other disposition of coal, other hard-mineral fossil fuels,[142] or a primary product thereof. Unlike the fiscal year 2013 budget proposal, this proposal does not use the additional revenue gained from limiting the domestic manufacturing deduction to increase the deduction rate for the manufacture of advanced technology property.[143]

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[141] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 88.

[142] The hard mineral fossil fuels to which the exclusion would apply include lignite and oil shale to which a 15-percent depletion rate applies.

[143] See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 93.

PART VIII – OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS

A. Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives

Present Law

In general

Under present law, taxes are imposed at different rates for distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the Alcohol and Tobacco Tax and Trade Bureau ("TTB"), Department of the Treasury, except these taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau ("CBP"), Department of Homeland Security, under delegation by the Secretary of the Treasury.

The following table outlines the present rates of tax on distilled spirits, wine, and beer:

Tax (and Code Section)	Tax Rates
Distilled spirits (sec. 5001)	$13.50 per proof gallon[144]
Wines (sec. 5041)[145]	
"Still wines"[146] not more than 14 percent alcohol	$1.07 per wine gallon[147]
"Still wines" more than 14 percent, but not more than 21 percent, alcohol	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

[144] A proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol.

[145] A small wine producer (not more than 250,000 wine gallons produced during the calendar year) is eligible for a small producer credit equal to $0.90 per wine gallon on the first 100,000 wine gallons removed during the year. Sec. 1041(c).

[146] A "still wine" is a non-carbonated wine. Most common table wines are still wines.

[147] A wine gallon is a U.S. liquid gallon.

Tax (and Code Section)	Tax Rates
Hard apple cider[148]	$0.226 per wine gallon
Beer (sec. 5051)[149]	$18 per barrel (31 gallons) generally

The liability for the excise tax on distilled spirits comes into existence at the moment the alcohol is produced but is not determined and payable until the bottled distilled spirits are removed from the bonded premises of the distilled spirits plant. The liability for the excise taxes on wine and beer also comes into existence when the alcohol is produced but is not payable until the wine or beer is removed from the bonded wine cellar or winery or brewery for consumption or sale. Generally, bulk distilled spirits and bulk and bottled wine may be transferred in bond between bonded premises and beer may be transferred between commonly owned breweries without payment of the tax; however, the tax liability follows these products.

Credit for wine content and for flavors content

Present law includes a tax credit ("the section 5010 credit") that reduces the distilled spirits tax rate for the alcohol content of a final product that is derived from the alcohol if wine or flavor is added to the product. For example, where still wine containing not more than 14 percent alcohol by volume and spirits are mixed, the wine portion will be taxed at $1.07 per wine gallon, and the distilled spirits portion at $13.50 per proof gallon.

Description of Proposal

The proposal repeals the section 5010 credit for distilled spirits and taxes all distilled spirit beverages at the $13.50 per proof-gallon rate.

Effective date.−The proposal is effective for all spirits produced in or imported into the United States after December 31, 2013.

Analysis

The section 5010 credit was initially enacted in 1980 with the intent to tax wine and flavor content as the wine and flavor content would have been taxed if the tax was imposed prior to blending the wine or flavor with distilled spirits.

The Administration argues that the section 5010 credit introduces differences in the prices of similar goods, thereby distorting decisions by producers and consumers.[150] The

[148] Hard apple cider is defined as apple cider otherwise classified as a still wine, the alcohol content of which is at least one-half of one percent but less than seven percent by volume.

[149] A small beer producer (not more than 2 million barrels of beer produced during the calendar year) is eligible for a reduced rate of $7.00 per barrel on the first 60,000 barrels removed during the year. Sec. 5051(a)(2).

[150] See also, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 2005, pp. 383-384.

Administration also argues that the credit currently encourages the use of wine and flavor additives. The Administration cites the substantial increase in the volume of wine and flavor additives from 1981 to 2011 to substantiate the argument that the credit encourages producers to use more wine and flavor content.

The Administration further argues the section 5010 credit favors foreign producers. It may be possible for a foreign producer to claim a higher credit, and attain a lower effective tax rate, than may be possible for a U.S. producer of a similar product. By regulation, the classification of some types of distilled spirits relies on compliance with foreign law.[151] The Administration suggests that a foreign producer could obtain a lower effective excise tax on a product sold in the United States than could a U.S. producer of the same product if foreign law permitted more flavor eligible for the section 5010 credit in the foreign product than did current U.S. regulations for the same product domestically produced. While such an outcome is possible in concept, it does not appear to occur in the market place. For example, one might think that the growing domestic market for flavored vodka and flavored gin would be one segment of the market where such an advantage for foreign producers might arise. However, the U.S. standards of identity for classes and types of distilled spirits do not distinguish between U.S. and foreign flavored vodka and flavored gin.[152] By regulation, these products are bottled at not less than 60 proof, and any product containing more than 2 ½ percent by volume of wine, must state the percentages as part of the designation. These standards are applied to U.S. and foreign products.

One segment of the distilled spirits market where current U.S. regulations give deference to foreign regulations governing distilled spirits is whiskeys.[153] The regulations specifically allow "Scotch whisky," "Irish whisky," and "Canadian whisky" to be labeled as such if they are manufactured in those countries in compliance with the law and regulations of Scotland, Ireland, and Canada.[154] In the U.S. market "Scotch whisky," "Irish whiskey," "Canadian whisky," "Bourbon whiskey," and "Tennessee sour mash," among other whiskey products, may be viewed by many consumers as distinct styles of products and not readily substituted for one another. If this is the case, the modest excise tax reductions achievable from the use of more permitted section 5010 flavors by certain foreign producers would produce little advantage to foreign producers at the expense of distillers of bourbon, Tennessee sour mash, and other American whiskeys. On the other hand, if consumers shop for whiskeys on the basis of alcohol content, it might be possible for foreign producers to achieve a lower effective excise tax for any given level of alcohol content in a whiskey and gain a price advantage in the market as suggested by the Administration.[155] There also could be some advantages to foreign producers as TTB is more

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[151] See 27 C.F.R. 5.22.

[152] 27 C.F.R. 5.22(i).

[153] The proper spelling is "whisky" for Scotch and Canadian whiskies and "whiskey" for Irish and American whiskeys. The TTB regulations refer to all such products as "whisky" and "whiskies."

[154] 27 C.F.R. 5.22(b)(5).

[155] There are flavored whiskeys for sale in the U.S. market, but these flavored products (*e.g.,* honey, hops, or herbs) generally are not produced using flavorings eligible for the section 5010 credit. See, for example, http://www.whiskyadvocateblog.com/2013/03/25/flavor-comes-to-scotch-whisky/.

readily able to enforce compliance on domestic producers. TTB is able to audit and verify the formulation of alcohol produced in the United States, but does not have authority for on-site audits of foreign producers. TTB does, however, have authority and does require foreign producers to provide information related to the formulation of products imported into the United States.

Computing and enforcing compliance with the section 5010 credit is complicated for producers and for TTB as it requires information about the specific components of the beverage rather than alcohol content alone.[156] Eliminating the credit could result in a more efficient allocation of TTB resources in administering and ensuring compliance with the tax laws.

[156] See also, General Accounting Office, *Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency* (GAO/GGD-90-123), September 1990, pp. 6-8.

B. Eliminate Section 404(k) Employee Stock Ownership Plan Dividend Deduction for Large C Corporations

Present Law

ESOPs in general

Tax-favored treatment applies to employer-sponsored retirement plans that meet certain qualification requirements ("qualified retirement plans").[157] An employee stock ownership plan ("ESOP") is a qualified defined contribution plan that is designated as an ESOP and is designed to invest primarily in stock of the employer, referred to as "qualifying employer securities."[158] An ESOP can be an entire plan or it can be a portion of a defined contribution plan. An ESOP can be maintained by either a C corporation or an S corporation.[159] For purposes of ESOP investments, a "qualifying employer security" is generally defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or of a member of the same controlled group) having a combination of voting power and dividend rights at least as great as any other class of common stock of the employer or related employer; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

Some ESOP rules provide tax treatment that is more favorable than that of other types of qualified retirement plans. For example, a shareholder of a closely held C corporation may defer recognition of gain realized on the sale of qualifying employer securities to an ESOP maintained by the C corporation if, immediately after the sale, the ESOP owns at least 30 percent of the total value of all outstanding stock of the corporation and if certain other requirements are met.[160] As another example, if a tax-exempt entity, including a qualified retirement plan, is a shareholder of an S corporation, its interest in the S corporation is treated as an interest in an unrelated trade or business and its pro rata share of S Corporation items of income, loss and deduction (and any gain or loss on disposition of the S corporation stock) are taken into account in computing the

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[157] Sec. 401(a).

[158] Sec. 4975(e)(7). Participant accounts under defined contribution plans other than ESOPs can also be invested in employer stock.

[159] A "C corporation" is so named because its tax treatment is governed by subchapter C of the Code (secs. 301-385). A C corporation is subject to tax on its net income and dividends paid to shareholders are generally subject to tax, resulting in two levels of tax. An S corporation is so named because its tax treatment is governed by subchapter S of the Code (secs. 1361-1379). An S corporation is a passthrough entity for income tax purposes. That is, income tax does not apply at the S corporation level. Rather, items of income, loss, deduction or credit are taken into account for tax purposes by the S corporation shareholders on their own tax returns.

[160] Sec. 1042.

unrelated business income tax ("UBIT") of the entity.[161] However, an exception to unrelated trade or business treatment applies with respect to employer securities held by an ESOP.[162]

Leveraged ESOPs

In order to prevent persons with a close relationship to a qualified retirement plan from using that relationship to the detriment of plan participants and beneficiaries, certain transactions between a qualified retirement plan and a disqualified person are prohibited.[163] A disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization of which any members are covered by the plan, and certain persons related to such disqualified persons. Transactions prohibited between the plan and a disqualified person include among others (1) the sale or exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, service, or facilities.

Under an exception to the prohibited transaction rules, an ESOP (but not any other qualified retirement plan) is permitted to borrow from the employer or other disqualified person, or the employer is permitted to guarantee a loan to an ESOP by a third party lender, in order for the ESOP to acquire qualifying employer securities (referred to as an "acquisition" loan).[164] An ESOP with an acquisition loan is referred to as a "leveraged" ESOP. The shares purchased with the loan proceeds are held in a suspense account under the plan and must be released and allocated to participant accounts as the loan is repaid.

Employer deductions for contributions to defined contribution plans

Employer contributions to a qualified defined contribution plan, including an ESOP, are deductible in an amount up to 25 percent of the participants' compensation.[165] In the case of an ESOP maintained by a C corporation, contributions to make principal payments on an

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[161] Sec. 512(e).

[162] Under section 409(p), certain restrictions apply in order to assure that an ESOP maintained by an S corporation benefits rank-and-file employees, as well as highly paid employees and historical owners of the S corporation, and that the ESOP is not used by S corporation owners to obtain inappropriate tax deferral or avoidance. These restrictions limit the amount of allocations of S corporation stock held by the ESOP to the accounts of certain persons. Section 4979A imposes an excise tax on the S corporation if these restrictions are violated.

[163] Sec. 4975. The Code imposes a two-level excise tax on prohibited transactions. The initial level tax is equal to 15 percent of the amount involved with respect to the transaction. An additional tax of 100 percent of the amount involved is imposed if the transaction is not corrected within a certain period.

[164] Sec. 4975(d)(3). To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan, the loan must be for a specific term, the interest on the loan must be at a reasonable rate, and any collateral given to a disqualified person by the plan must consist only of qualifying employer securities.

[165] Sec. 404(a). Deductible contributions can be made in the form of employer stock.

acquisition loan are subject to the general deduction limit of 25 percent of compensation, but the limit is applied separately to the contributions for principal payments on the loan, and contributions to make interest payments on the loan are deductible without regard to the limitation.[166]

Dividends (in the case of a C corporation) or distributions (in the case of an S corporation) made with respect to the ESOP shares purchased with the loan proceeds may be used to make payments (principal and interest) on the acquisition loan without violating the prohibited transaction rules or the qualification requirements.[167] In addition, a C corporation may deduct dividends paid on employer stock held by an ESOP ("ESOP dividends") that, in accordance with plan provisions, are: (1) paid in cash directly to plan participants, (2) paid to the plan and subsequently distributed to participants in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, (3) paid to the plan and reinvested in employer stock at the election of the participant (rather than being paid directly to the participant), or (4) used to make payments on an acquisition loan that was used to acquire the employer stock with respect to which the dividend is paid (whether or not the stock is allocated to participants).[168] This deduction is allowed without regard to the general deduction limits on contributions to qualified plans; however, the IRS may disallow the deduction for any ESOP dividend if it determines that the dividend constitutes, in substance, an avoidance or evasion of taxation.

The payment of dividends to participants as described above is permitted despite any rules applicable to qualified retirement plans that would otherwise prohibit distributions. Dividends paid to participants are includible in income, but are not subject to the additional 10-percent tax that generally applies to distributions before age 59½.[169]

Employee stock purchase plans

In general, if an employee receives stock from an employer, the difference between the fair market value of the stock and the price, if any, paid by the employee for the stock is included in the employee's gross income.[170] However, in the case of stock purchased by an employee at a

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[166] Sec. 404(a)(9)(A)-(C). See also Private Letter Ruling 200732028, August 10, 2010.

[167] Secs. 404(k)(5)(B) and 4975(f)(7). If the dividend or distribution is paid with respect to stock allocated to a participant's account, the plan must allocate employer securities with a fair market value of not less than the amount of such distribution to the participant for the year in which the dividend or distribution would have been allocated to such participant.

[168] Sec. 404(k).

[169] Sec. 72(t)(2)(A)(vi).

[170] Sec. 83. The employer is generally allowed a deduction for the amount included in gross income by the employee.

discount under an employee stock purchase plan, the employee does not recognize income on receipt of the stock.[171]

An employee stock purchase plan must meet various requirements, including requirements as to coverage of employees, the purchase price of the stock, and the amount of stock available to an employee. Under the plan, the opportunity to purchase stock must be provided to all nonhighly compensated employees of the employer (with exceptions for employees who have been employed for less than two years and employees whose customary employment is 20 hours or less per week or not more than five months in any calendar year). The plan may also cover highly compensated employees, but not five-percent shareholders of the employer. The plan must provide that the option price is not less than the lesser of 85 percent of the fair market value of the stock at the time of the right to purchase the stock is granted or 85 percent of the fair market value of the stock at the time of purchase. In addition, the plan may not provide any employee with the opportunity to purchase for any calendar year stock with a fair market value of more than $25,000, determined as of the time the right to purchase the stock is granted.

Description of Proposal

The proposal repeals the deduction for C corporation dividends paid with respect to employer stock held by an ESOP, with an exception for C corporations with annual receipts of $5 million or less. Nondeductible C corporation dividends and S corporation distributions may be used to repay an acquisition loan (or, in the case of C corporation dividends, paid out to participants) as under present law without violating the prohibited transaction rules or the qualification requirements, subject, under the proposal, to recharacterization if the IRS determines that the dividend or distribution is unreasonable or constitutes, in substance, an avoidance or evasion of taxation. As under present law, dividends paid to participants are includible in income, but not subject to the 10-percent additional tax.

Effective date.−The proposal applies to dividends paid after date of enactment.

Analysis

ESOP rules generally

The favorable tax rules for ESOPs are intended to encourage ownership by employees of the business for which they work, giving them a greater opportunity to accumulate assets by sharing in the profitability of the business (in addition to their compensation). Some suggest also that employee ownership results in greater employee productivity because they have a "stake" in the business. Studies are inconclusive as to the extent to which ESOPs achieve the intended results. In addition, some raise concerns about employees having too much of their retirement

[171] Secs. 421 and 423. The employer is not allowed any deduction with respect to the stock received by the employee. However, if the employee disposes of the stock within a specified period (referred to as a "disqualifying disposition"), the employee recognizes income and the employer is allowed a corresponding deduction for the year of the disposition. Similar rules apply to stock acquired on exercise of an incentive stock option under section 422.

savings concentrated in employer stock. Besides instances of ESOP successes are instances in which businesses maintaining ESOPs have failed, causing employees to lose retirement savings as well as their jobs.

The proposal suggests that, to the extent ESOP dividends have a productivity incentive effect, the effect may be more likely in small firms so that the beneficial effect may justify the risk to retirement savings. The proposal attempts to strike a balance between these considerations in the case of smaller C corporations (measured as those with annual receipts of up to $5 million) by retaining the dividend deduction for smaller C corporations.

While recognizing the value to employees of owning employer stock, some argue that it is not an appropriate investment for retirement plan assets, at least not at the level required for an ESOP (that is, employer stock as the primary investment under the plan). They suggest that employee stock purchase plans offer a more appropriate vehicle for employees to acquire and hold employer stock and that retirement savings should be invested in other, more diversified assets. Some propose elimination of all special rules for ESOPs and for employer stock held in qualified retirement plans. In contrast, the proposal merely limits one of several tax benefits available to C corporations that sponsor ESOPs, but leaves in place other provisions that afford favorable treatment to ESOPs, their participants, and their sponsors.

Elimination of dividend deduction

The present-law deduction for C corporation dividends paid with respect to ESOP-owned stock effectively allows a C corporation to avoid corporate-level tax on the ESOP's share of the C corporation's distributed income. This increases the C corporation's after-tax income, thus potentially increasing stock value or the amount of dividends paid to shareholders. However, this benefit flows to all shareholders, not just to the ESOP and the ESOP participants. In addition, because dividends paid to the ESOP, which is tax-exempt, are not subject to tax when paid and may not be distributed to participants until a later year, the deduction may have the effect of not just eliminating the corporate-level tax, but also deferring the shareholder-level tax. Some may therefore view repeal of the dividend deduction as consistent with corporate tax policy.

Some may be concerned that the proposal will discourage larger C corporations from maintaining ESOPs. Others may feel that the other tax advantages associated with ESOPs provide sufficient incentive. For example, a C corporation sponsoring a leveraged ESOP can continue to get an additional deduction for contributions to pay principal and interest on the acquisition loan. Moreover, some C corporations sponsoring ESOPs may be able to avoid entity-level tax by converting to S corporation status. In that case, the S corporation will pay no corporate-level tax on its income nor is the ESOP subject to tax on its share of the S corporation income. Instead, distributions from the ESOP to participants will be includible in participants' income only when made. This is comparable to the tax treatment under present law of C corporation earnings paid to an ESOP in the form of dividends that are deducted by the C corporation.

Under the proposal, C corporations with annual receipts of $5 million or less can continue to deduct applicable dividends from taxable income. Since C corporations with annual

receipts slightly greater than $5 million will receive no deduction for ESOP dividends, the proposal may discourage growth at C corporations with annual receipts at or slightly below the $5 million threshold. This disincentive effect would be mitigated if the deduction for ESOP dividends were phased out rather than eliminated entirely for C corporations above the threshold.

Payment of dividends to participants

The proposal continues to allow dividends on C corporation stock held by an ESOP to be paid to participants currently, even if qualification requirements would otherwise prohibit distributions. Some view the present-law rule as inconsistent with retirement savings policy in that it encourages "leakage," that is, distributions other than during retirement.

Before 2002, with the exception of dividends used to repay an acquisition loan, dividends on C corporation stock held by an ESOP were deductible only if paid to participants currently, with revenues attributable to income inclusion by participants offsetting the revenue loss associated with the dividend deduction. However, retirement savings policy led to the present-law rule that allows the dividend deduction also in cases where participants elect to reinvest the dividends under the ESOP.

Some may argue that repeal of the deduction under the proposal should be coupled with repeal of the rule allowing ESOP dividends to be paid to participants currently. In the case of a C corporation with annual receipts in the range of $5 million, however, it may not be clear whether dividends will be deductible and, therefore, not clear whether dividends may be paid to participants currently.

PART IX − TAX RELIEF TO CREATE JOBS AND JUMPSTART GROWTH

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

Description of Modification

The fiscal year 2014 budget proposal modifies the prior year budget proposal by reducing from $5 billion to $2.5 billion the proposed increase in allocable advanced energy project credits.[172]

[172] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 15.

B. Designate Promise Zones

Description of Modification

The fiscal year 2013 budget proposal is modified by changing "growth" zones to "promise" zones, changing the start date to 2015, and relaxing the requirement of a nomination to that of formal support.[173]

[173] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 152.

PART X − INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE

A. Create America Fast Forward Bonds and Expand Eligible Uses

Present Law

Tax-exempt bonds

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

The definition of a qualified private activity bond includes an exempt facility bond,[174] or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[175] A qualified 501(c)(3) bond is a bond issued by a State or local government for the capital expenditures and limited working capital expenditures of charitable organizations described in (and recognized under) section 501(c)(3).

Often to take advantage of a better interest rate after issuance, bonds are refinanced ("refunded"). A current refunding is when the original bonds are replaced with a new issue within 90 days of the issuance of the new bonds. There is no restriction on the number of current refundings that can be undertaken. After a current refunding is complete, only one set of bonds remains outstanding. There is a limit on "advance refundings." An advance refunding is when two sets of bonds remain outstanding for a period longer than 90 days. This often occurs because the issuer has offered "call protection" preventing the issuer from retiring the bonds for specified period of time because the issuer has promised to pay interest on those bonds for a certain uninterrupted length of time. The interest on both sets of bonds outstanding remains tax-exempt. In general, governmental bonds and qualified 501(c)(3) bonds are allowed to be advance

[174] Exempt facility bonds are bonds issued to finance: (1) airports; (2) docks and wharves; (3) mass commuting facilities; (4) high-speed intercity rail facilities; (5) facilities for the furnishing of water; (6) sewage facilities; (7) solid waste disposal facilities; (8) hazardous waste disposal facilities; (9) qualified residential rental projects; (10) facilities for the local furnishing of electric energy or gas; (11) local district heating or cooling facilities; (12) environmental enhancements of hydroelectric generating facilities; (13) qualified public educational facilities; (14) qualified green building and sustainable design projects; or (15) qualified highway or surface freight transfer facilities. Sec. 142(a).

[175] Sec. 141(e).

refunded once.[176] Private activity bonds, other than qualified 501(c)(3) bonds may not be advance refunded.

Tax-credit and direct-pay bonds

In general

A taxpayer holding a tax-credit bond on a credit allowance date is entitled to a tax credit. In general, the amount of the credit is determined by multiplying the bond's credit rate by the face amount[177] on the holder's bond. The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

Issuers may elect to issue the following tax-credit bonds as "direct-pay bonds": new clean renewable energy bonds (new CREBs), qualified school construction bonds, and qualified energy conservation bonds. With direct-pay bonds, the issuer pays the bond holder interest and the Federal government pays to the issuer a subsidy in the amount of the applicable tax credit.

Qualified School Construction Bonds

Qualified school construction bonds (QSCBs) are a type of tax-credit bond, the proceeds of which are to be used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed with part of the proceeds of such issue. There is a national bond limitation authorization for QSCBs of $11 billion for 2009 and $11 billion for 2010, however, unused limitation may be carried over to future calendar years until fully used. An additional $400 million of QSCBs are authorized to be issued for Indian schools. Through the end of 2012, approximately $15.6 billion of QSCBs have been issued.[178]

As noted above, qualified school construction bonds may be issued as direct-pay bonds. The level of subsidy payable to the issuer is 100 percent of the tax credit that would have been due to the bond holder.

Build America Bonds

Under prior law, State and local governments were permitted to issue direct-pay Build America bonds (BABs). Enacted in 2009, the authority to issue BABs expired after December 31, 2010. A Build America Bond is any State or local governmental obligation (other than a private activity bond) if the interest on such obligation would be excludable otherwise from gross

[176] See sec. 149(d).

[177] The "face amount" (or par value) represents the value of a bond at maturity as stated on the bond certificate. In the case of new CREBs and qualified energy conservation bonds, the credit is reduced to 70 percent of the amount otherwise determined. Secs. 54C and 54D.

[178] 2013 Bond Buyer Yearbook.

income under section 103 (relating to the tax-exemption for State and local government obligations). The interest paid with respect to a BAB is included in the holder's gross income. A BAB could not be a private activity bond. A BAB could be issued two different ways, as a tax-credit bond, allowing the holder to accrue a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year, or a direct-pay bond with the bondholder receiving interest included in gross income and the issuer receiving a Federal subsidy in the form of a payment equal to 35 percent of the interest payable on the bond. Most, if not all, issuers of BABs elected to issue direct-pay BABs with the subsidy paid by the Federal government to the issuer.

In addition to disqualifying all private activity bonds from being BABs, BABs could only be used for capital expenditures, not working capital. The Code did not provide for refundings of BABs after the expiration date for issuance.

Description of Proposal

America Fast Forward Bonds

The proposal creates a permanent direct-pay America Fast Forward Bonds (AFFBs) program at a Federal subsidy level equal to a fixed percentage of 28 percent of the coupon interest on the bonds. The proposal provides the following as eligible uses for AFFBs: (1) original financing for governmental capital projects; (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, such as nonprofit hospitals and universities.

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.

Effective date.−The proposal is effective for bonds issued on or after January 1, 2014.

America Fast Forward Bonds for School Construction

The proposal provides a temporary 50-percent Federal subsidy rate for AFFBs 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. For AFFBs 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. The 50-percent Federal subsidy rate would not apply to refundings of prior governmental capital financings for public schools and state universities or refundings of prior financings for section 501(c)(3) educational entities.

Effective date.−The proposal is effective for bonds issued in 2014 and 2015.

Analysis

America Fast Forward Bonds - In general

In substance the America Fast Forward Bonds program is very similar to the Build America Bond program. Both programs involve "direct-pay" bonds, providing a subsidy to the issuer for governmental capital projects. The primary differences are a lower subsidy rate (28 percent for AFFB instead of 35 percent BAB rate), an expansion of eligible uses for AFFB proceeds beyond government capital projects (to include working capital, projects and programs that can be funded with qualified private activity bonds, and current refundings); and the AFFB program is permanent, rather than a two-year program as was the BABs program.

Because of the similarities between the proposed AFFBs and BABs, the experience with BABs is useful in analyzing the AFFB proposal.

Experience with BABs

BABs have been used in all 50 States, the District of Columbia and two territories for approximately $184 billion in BABs financing of capital projects.[179] BABs were intended to assist State and local governments during the recent fiscal crisis by lowering borrowing costs and encouraging job growth by providing an additional method of finance for the building of capital projects. During 2008, as the financial problems worsened, investors sought the safety of U.S. Treasury bonds. The pool of investors for tax-exempt debt declined, and State and local governments had to offer higher interest rates to attract buyers for their bonds. As a result, State and local governments faced an environment of sharply increasing borrowing costs.

BABs addressed the borrowing-cost issues by providing a direct Federal subsidy of interest payments to reduce the direct borrowing costs for State and local governments.[180] BABs also broadened the potential pool of municipal bond investors to include low tax and zero tax liability investors that normally would not hold tax-exempt debt. BAB issuers receive a subsidy of 35 percent of the interest paid to buyers of the bonds. (Although the program expired January 1, 2011, the Federal government's obligation to subsidize the interest payments continues for the life of the outstanding bonds.) The subsidy permitted the issuers to pay interest rates that were competitive with rates paid on taxable debt by corporations and the Federal government. As a

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[179] Statistics of Income, Internal Revenue Service, *Taxable Direct Payment Bonds* (Table 12), which is available at http://www.irs.gov/uac/SOI-Tax-Stats-Tax-Exempt-Bond-Statistics. See also, Department of the Treasury, *Treasury Analysis of Build America Bonds, Issuance, and Savings*, May 16, 2011, p. 2, which is available at http://ww.treasury.gov/initiatives/recovery/documents/BABs%20report.pdf. In addition, for another study of the BABs program, see Andrew Ang, Vineer Bhansali, and Yuhang Xing, Build American Bonds, National Bureau of Economic Research Working Paper No. 16008, May 2012.

[180] In addition to reducing the borrowing costs to State and local governments, the Federal subsidy may offer a measure of security for the investor as a portion of the interest is covered by the Federal government, thus encouraging the purchase of these bonds.

result, BABs expanded the categories of municipal investors to include buyers such as pension funds and foreign entities without tax liability and also to include certain other financial institutions that are subject to special rules that limit the benefits of holding tax-exempt bonds. Most BABs have been issued with long maturities, which made the bonds attractive to investors looking for a stable, long-term, high rate of income and those trying to match income with their long-term obligations, such as pension funds.

One could reasonably expect that the AFFB program could have similar benefits for the municipal market by expanding the types municipal investors to include those with low or no tax liability. On the other hand, some argue that the attractiveness to issuers of BABs was lessened by the effect of the Federal budget sequestration. The Balanced Budget Act of 1985, as amended, required certain automatic reductions, which included BAB subsidy payments to issuers. For claims filed with the IRS after September 30, 2013, a sequestration reduction rate of 7.2 percent is applied to those payments (down from 8.7 percent for March 1, 2013, through September 30 2013). Some argue that issuers made financial plans and projections based on a 35 percent subsidy. As a result, a few issuers have recalled their BABs, citing the reduction in Federal payments as an extraordinary circumstance warranting retirement of the bonds. The budget proposal does not address the effect of sequestration on direct-pay bond payments to issuers, as a result, the uncertainty surrounding the current and possible future reductions could make the AFFB program less attractive to issuers. The risk of sequestration could result in fewer projects financed with AFFBs, however, tax-exempt bonds remain a viable option to the AFFB program for these types of projects.

Permanence

The President's budget proposes a permanent direct-pay bond program. In some cases, it was observed that BABs paid higher interest rates and fees (e.g., underwriting fees) than comparable corporate bonds, which some attributed to the new and temporary nature of the BAB program. A May 2011 Treasury Department analysis indicates that the financing costs for BABs declined over time.[181] Some would argue that permanence would strengthen the market for these types of bonds and permit them to be issued at lower interest rates and with lower associated fees.

Market participants are more likely to devote resources necessary for issuer and investor education if a program is permanent than if there is uncertainty about the long-term prospects of a program that sunsets after two years. In addition, a permanent program may alleviate some of the uncertainty associated with a program that is continually extended, and, as such, receives periodic reevaluation that may result in substantial changes to the form of the program.

Opponents of the proposal would argue that the purpose of the BAB program was to provide temporary help to State and local governments during a period of financial crisis and therefore, any successor to that program also should not be permanent.

[181] U.S. Treasury Department, *Treasury Analysis of Build America Bonds, Issuance, and Savings*, May 16, 2011, p. 10.

Some may be concerned about a permanent program's effect on the Federal deficit. Although the BABs program expired January 1, 2011, the Federal government's obligation to subsidize the interest payments continues for the life of the outstanding bonds. The program was without volume limitations and most BAB issuances were for the long-term, e.g., 20 to 30 years, thus committing the Federal government to significant costs for decades outside the 10-year budget window. Unlike spending programs that are generally part of an annual appropriations process, the outlays for the BAB program are treated as tax refunds which are outside the annual appropriations process. The AFFB program is similarly without volume limitations (except for certain qualified private activity bonds) and based on the BABs experience, is expected to mostly involve long-term debt committing the Federal government to significant costs over the long-term.

As compared to traditional tax-exempt bonds that would potentially be replaced with AFFB borrowing, however, a direct-pay bond program arguably delivers a Federal borrowing subsidy more efficiently. The value of the subsidy does not vary with the marginal tax bracket of the investor and each dollar of subsidy is paid directly to the State or local governmental issuer.

Level of interest subsidy

At 35 percent, the BAB subsidy was significantly deeper than that provided by tax-exempt debt. Studies have found that the BAB provision lowered the interest rate paid by State and local governments. For example, a 2010 Treasury Report found that BABs lowered interest rates by 112 basis points on a 30-year bond.[182] Another study indicated savings ranging from 31 basis points up to 112 basis points from issuing BABs instead of tax-exempt bonds.[183] The proposed subsidy for the AFFB program is 28 percent of interest paid.

While forecasting the relationships between tax-exempt debt and direct-pay bonds in the future is speculative, using data on the historical relationships between taxable and tax-exempt debt suggest that a direct-pay bond at the 28 percent credit rate may still provide a deeper subsidy than comparable tax-exempt debt for at least some projects and, in particular, for long-term debt.

Expanded purposes

Current refundings

The President's budget proposal would allow current refundings of AFFBs in which the prior bonds are retired within 90 days after issuance of the current refunding bonds. As noted above, current refundings are done primarily to replace higher-rate debt with lower-rate debt to

[182] "Treasury Analysis of Build America Bonds and Issuer Net Borrowing Costs," available at http://www.treasury.gov/initiatives/recovery/Documents/BABs-Report-4-2-2010-FINAL.pdf

[183] Liu, Gao and Denison, Dwight V., "Indirect and Direct Subsidies for Cost of Government Capital: Comparing Tax-Exempt Bonds and Build America Bonds," February 19, 2011. Available at SSRN: http://ssrn.com/abstract=1764703.

obtain interest cost savings. The interest cost savings in allowing current refunding of AFFBs would benefit both issuers (lower interest rates) and the Federal government (lower AFFBs subsidy rate). Historically, State and local government issuers have had a preference for debt with par call features after 10 years. In certain circumstances, issuers issue either noncallable bonds or bonds with significant "make whole" call premiums to preserve the economic terms of the original debt, and in these circumstances, current refunding will not produce interest cost savings.

Working capital

The President's budget proposal for AFFBs would expand the permitted purposes beyond governmental capital projects that were allowed under BABs, to include government working capital. This is a purpose for which tax-exempt debt may be issued under present law, and so some argue that allowing this purpose make AFFBs a more viable alternative to tax-exempt debt for State and local governments. Proponents argue that direct-pay bonds are more efficient in delivering the Federal subsidy to the issuers than tax-exempt debt, and so this alternative should be further encouraged.

Because State and local government receipts from property and sales taxes often are uneven from month to month (due to seasonal or other timing issues), the governments issue tax-exempt debt to cover the temporary shortfall and to cover operating expenses until the revenue is actually received. Some may argue that while there is a clear Federal interest in capital investment programs that could create jobs, the Federal interest in providing an increased subsidy for financing working capital is less clear.

Qualified 501(c)(3) and other private activity bonds

As noted above, the budget proposal provides AFFB financing for section 501(c)(3) entities and other present-law qualified private activity bond purposes. Some might argue this is appropriate for 501(c)(3) entities as such entities are performing functions that might otherwise have to be done by government, and thus are performing a quasi-governmental function. However, some might question whether there is a significant Federal interest in subsidizing the expenditures of such private non-profit organizations. In a private activity bond issuance, the State or local government issuer is acting as a conduit to enable a private party to benefit from lower-cost tax-exempt financing. Thus, when the primary beneficiary of a Federally subsidized bond is a private organization for using facilities for a private trade or business, one might argue that the Federal government should not intervene in the market this way and private entities should compete with other private entities to obtain their financing directly from the market instead of using a State or local government as a conduit. On the other hand, some might argue that certain private activity bonds that provide infrastructure, such as airports, docks, wharves, water and sewer systems, are providing commerce and community benefits beyond the benefits to the private business and therefore, a subsidy is warranted.

AFFBs for School Construction

As noted above, qualified school construction bonds may be used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a

facility is to be constructed. Qualified zone academy bonds, another type of tax credit bond, are also available for certain public schools. Qualified 501(c)(3) bonds (a type of tax-exempt bond) are available for schools, including universities, that are recognized 501(c)(3) organizations. In addition, there are tax-exempt bonds available for schools operated under public-private partnerships. Furthermore, governmental tax-exempt bonds can be issued for public schools and universities. Some might argue that existing bond provisions are sufficient financing subsidies for schools and that an additional financing mechanism is not needed. Some note that QSCBs, the current tax credit bond program with a direct-pay option, subsidize 100 percent of interest costs and are not being fully utilized (more than $6 billion of authorized authority remaining unused).[184] Opponents might argue that if a 100 percent interest subsidy bond cannot be fully utilized, a temporary two-year program at 50 percent similarly will be undersubscribed. Some may argue that the 50 percent subsidy is excessive, given that the BAB subsidy at 35 percent was acknowledged as much deeper than the current tax-exempt bond subsidy.

Some may argue that the current bond incentives are tilted more toward primary and secondary public education, rather than post-secondary education at the university level. As a result, AFFBs for school construction will provide additional financing options for post-secondary education, private primary and secondary schools. In addition, AFFBs for school construction are unconstrained by a volume cap. Some may argue that universities with large endowments have no need for further financing options but are eligible to benefit from this financing tool under the proposal. On the other hand, the temporary nature of the program may discourage market participants from utilizing this option as two years may be insufficient time for market participants to devote resources to using a new program when more well-established programs already exist.

[184] For a listing of QSCB issuances through August 2013, see Bond Buyer, *Qualified School Construction Bonds in 2010-13*, available at http://www.bondbuyer.com/pdfs/QSCB.pdf.

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

Prior and Present Law

Qualified 501(c)(3) bonds

Under present law, State and local governments may issue tax-exempt bonds to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds"). The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) may be financed with qualified 501(c)(3) bonds.

Volume limitation

State volume cap

Unlike governmental bonds, the aggregate volume of most qualified private activity bonds is restricted by the present-law annual volume cap imposed on issuers within each State.[185] The per-State volume cap rules reflect Congress' intent to control the total volume of tax-exempt bonds issued for private activities. For calendar year 2013, the amount for calculating the volume cap is the greater of $95 multiplied by the State population, or $291,875,000 (the "small population State minimum"). Qualified 501(c)(3) bonds are not subject to the State volume cap.

$150 million limit

Present and prior law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. Under prior law, the most significant of these restrictions limited the amount of outstanding bonds from which a section 501(c)(3) organization could benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control were treated as a single organization. The limit did not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

The Taxpayer Relief Act of 1997 repealed the $150 million limit for bonds issued after the date of enactment to finance capital expenditures incurred after the date of enactment.[186] Because this provision of the Taxpayer Relief Act of 1997 applies only to bonds issued with respect to capital expenditures incurred after the date of enactment, the $150 million limit continues to govern issuance of other non hospital qualified 501(c)(3) bonds (e.g., refunding

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[185] Sec. 146.

[186] The Taxpayer Relief Act of 1997, Pub. L. No. 106-134, was enacted on August 5, 1997.

bonds with respect to capital expenditures incurred before the date of enactment or new money bonds for capital expenditures incurred before that date).

Description of Proposal

The $150 million limit is repealed in its entirety for bonds issued after the date of enactment.

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

Analysis

The present-law rules require significant record-keeping and administrative burden to ensure that each 501(c)(3) bond is in compliance. Also, since most 501(c)(3) bonds are not subject to any type of volume limit, it is unclear that any significant tax policy is being advanced by the present-law rules with such limited application. Perhaps a better way to discourage over-issuance of these bonds is to create a more comprehensive legislative framework.

C. Increase Number Qualified Private Activity Bonds for Qualified Highway and Surface Freight Transfer Facilities

Present Law

In general

Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[187]

Exempt facility bonds

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[188] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); qualified residential rental projects; privately owned and/or operated utility facilities (water, sewage, solid waste disposal, certain private electric and gas facilities, local district heating and cooling facilities, qualified hazardous waste facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building, and sustainable design projects.[189]

Airports

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

Port facilities

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

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[187] Sec. 141(e).

[188] Sec. 142(a).

[189] Sec. 142(a).

Mass commuting facilities

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

High-speed intercity rail facilities

The definition of an exempt facility bond includes bonds issued to finance high-speed intercity rail facilities.[190] A facility qualifies as a high-speed intercity rail facility if it is a facility (other than rolling stock) for fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas.[191] The facilities must use vehicles that are reasonably expected to be capable of attaining a maximum speed in excess of 150 miles per hour between scheduled stops, and the facilities must be made available to members of the general public as passengers.

Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned. However, if the bonds are to be issued for a nongovernmental owner of the facility, such owner must irrevocably elect not to claim depreciation or credits with respect to the property financed by the net proceeds of the issue.[192]

The Code imposes a special redemption requirement for these types of bonds. Any proceeds not used within three years of the date of issuance of the bonds must be used within the following six months to redeem such bonds.[193]

Seventy-five percent of the principal amount of the bonds issued for high-speed rail facilities is exempt from the State volume cap.[194] If all the property to be financed by the net proceeds of the issue is to be owned by a governmental unit, then such bonds are completely exempt from the State volume cap.

Qualified highway or surface freight transfer facility bonds

Present law authorizes the issuance of tax-exempt private activity bonds to finance qualified highway or surface freight transfer facilities. A qualified highway facility or surface freight transfer facility is any surface transportation or international bridge or tunnel project (for

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[190] Secs. 142(a)(11) and 142(i).

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

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

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

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

which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code or any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Qualified highway or surface freight transfer facility bonds are not subject to the State volume limitations. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.[195] Similar to the requirement for high-speed

[195] As of May 10, 2013, from the $15 billion in qualified highway or surface freight transfer facility bond authority, the Department of Transportation had made the following allocations (bonds issued where indicated):

Project	PAB Allocation
Bonds issued	
Capital Beltway HOT Lanes, Virginia	$589,000,000
North Tarrant Express, Texas	$400,000,000
IH 635 (LBJ Freeway), Texas	$615,000,000
Denver RTD Eagle Project (East Corridor and Gold Line), Colorado	$397,835,000
CenterPoint Intermodal Center, Illinois	$225,000,000
Downtown Tunnel/Midtown Tunnel/MLK, Virginia	$675,004,000
I-95 HOV/HOT Project, Virginia	$252,648,000
East End Crossing, Ohio River Bridges	$676,805,000
Subtotal	**$3,831,292,000**
Allocations	
Knik Arm Crossing, Alaska	$600,000,000
CenterPoint Intermodal Center, Illinois	$1,086,000,000
CenterPoint Intermodal Center, Missouri	$475,000,000
U.S. 36 Managed Lanes/BRT Phase 2, Colorado	$100,000,000
Project	**PAB Allocation**
East End Crossing, Indiana	$98,195,000

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

Volume limitation

Most qualified private activity bonds are subject to annual State volume limitations (the "State volume cap"). For calendar year 2013, the State volume cap, which is indexed for inflation, equals $95 per resident of the State, or $291,875,000, if greater. Exceptions from the State volume cap are provided for bonds issued for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal), bonds that are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds), and 501(c)(3) bonds.

Description of Proposal

The proposal increases the national volume limit for qualified highway or surface freight transfer facilities from $15 billion to $19 billion.

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

Analysis

The proposal provides an incentive to increase total investment in qualified highway or surface freight transfer facilities by providing a lower cost source of financing for such projects. It is argued that the proposal would have positive economic effects in the United States. The types of projects eligible for tax-exempt financing under the proposal may provide benefits that may not be fully captured by the owners of the facilities. If this is the case, then the private market would provide too little investment in these projects.

Goethals Bridge, New York	$1,200,000,000
North Tarrant Expressway 3A & 3B	$450,000,000
I-77 Managed Lanes	$350,000,000
Subtotal	**$4,359,195,000**
Total PAB allocations and issuance	**$8,190,487,000**

Source: Federal Highway Administration [http://www.fhwa.dot.gov/ipd/fact_sheets/pabs.htm].

Opponents may question whether the proposal is necessary. As of August 9, 2013, only 52 percent of the existing private activity volume cap for qualified highway or surface freight transfer facilities has been issued or allocated.

D. Exempt Water Infrastructure from Private Activity Volume Cap

Present Law

In general

Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[196]

Exempt facility bonds

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[197] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); qualified residential rental projects; privately owned and/or operated utility facilities (water, sewage, solid waste disposal, certain private electric and gas facilities, local district heating and cooling facilities, qualified hazardous waste facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building, and sustainable design projects.[198]

Water facilities

The Code permits the issuance of exempt facility bonds for water facilities. This provision covers facilities furnishing water that is made available to the general public, including electric utility, industrial, agricultural, or other commercial users. Such facilities must be operated by a governmental unit or the rates for the furnishing or sale of water must be established or approved by a governmental unit.

Sewage facilities

The Code permits the issuance of exempt facility bonds for sewage facilities. This includes property used for certain levels of treatment of wastewater and property used for collection, storage, use, processing, or final disposal of wastewater, sewage, or septage.

Solid waste disposal facilities

The Code permits the issuance of exempt facility bonds for solid waste disposal facilities. This includes a facility that processes solid waste in a qualified solid waste disposal process,

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[196] Sec. 141(e).

[197] Sec. 142(a).

[198] Sec. 142(a).

performs a preliminary function (such as to collect, separate, sort, store, treat, process, disassemble, or handle solid waste), or is functionally related and subordinate to such a facility.

Solid waste means garbage, refuse, and other solid material derived from any agricultural, commercial, consumer, governmental, or industrial operation or activity if the material is either used material or residual material and the material is reasonably expected to be introduced within a reasonable time into a qualified solid waste disposal process. Solid waste does not include virgin material, solids within liquids and liquid waste, precious metals, hazardous material, or radioactive material.

A qualified solid waste disposal process includes a final disposal process, energy conversion process, or recycling process.

Facilities for the local furnishing of electric energy or gas

The Code permits the issuance of exempt facility bonds for facilities for the local furnishing of electric energy or gas. This generally includes a facility furnishing electric energy or gas serving an area not to exceed two contiguous counties or a city and one contiguous county. The use of this financing is limited to financing a facility for the local furnishing of gas or electricity only if (1) the facility will be used by a person who is engaged in the local furnishing of that energy source on January 1, 1997, and be used to provide service within the area served by such person on January 1, 1997 (or with a county or city any portion of which is within such area) or (2) the facility will be used by a successor in interest to such person for the same use and within the same service area as described in (1).

Local district heating or cooling facilities

The Code permits the issuance of exempt facility bonds for local district heating and cooling facilities. Such a facility provides hot water, chilled water, or steam to two or more users for residential, commercial, or industrial heating or cooling, or process steam.

Hazardous waste disposal facilities

Facilities for the incineration or permanent entombment of hazardous waste are permitted to be financed by exempt facility bonds if certain requirements are met.

Environmental enhancements of hydro-electric generating facilities

Environmental enhancements of hydroelectric generating facilities means property the use of which is related to a Federally licensed hydroelectric generating facility owned and operated by a governmental unit and that (1) protects or promotes fisheries or other wildlife resources, including any fish by-pass facility, fish hatchery, or fisheries enhancement facility; or (2) is a recreational facility or other improvement required by the terms and conditions of any Federal licensing permit for the operation of such generating facility. A bond is not considered an exempt facility bond for this purpose unless at least 80 percent of the net proceeds of the issue of which it is a part are used to finance property described in (1).

Description of Proposal

The proposal exempts exempt facility bonds for water facilities and sewage facilities from the private activity bond volume cap.

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

Analysis

With exempt facility bonds for water and sewage facilities exempt from the private activity bond volume cap, financing for these projects would not have to compete with those bonds still subject to the volume cap for private activity bond authority. This may make more debt financing available for more projects at the lower interest rates that tax-exempt bonds permit. This lower cost financing may encourage more construction of water facilities and sewage facilities.

Exempting bonds for water and sewage facilities from the private activity volume cap expands a subsidy that Congress has previously curtailed with the enactment of the State volume cap in 1986. Proponents may argue that such a subsidy is justified because, while the benefits of such financing to owners of water and sewage facilities are inherently private in nature, there may be positive externalities associated with clean water and sewage treatment (*e.g.*, public health). However, there may be negative externalities associated with these projects as well (*e.g.*, the effect of reduced river flow from water extraction on fish population, or the odor of a nearby sewage treatment facility). In either case, these externalities are likely to be highly localized and may not warrant Federal intervention.

E. Increase the 25-Percent Limit on Land Acquisition Restriction on Qualified Private Activity Bonds

Present Law

In general

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds generally are bonds for which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income of interest on State and local bonds does not apply to private activity bonds unless the bond is a qualified private activity bond that satisfies certain requirements. "Qualified private activity bond" means an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, section 501(c)(3), or student loan bond. To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities), privately owned and/or operated public works facilities, and certain other facilities specifically identified in the Code.

Limitation on use for land acquisition

General rule

The Code provides that a private activity bond is not a qualified bond if 25 percent or more of the net proceeds of an issue are to be used (directly or indirectly) for the acquisition of land (or an interest therein). A bond also is not a qualified bond if any portion of the proceeds is to be used (directly or indirectly) for the acquisition of land (or an interest therein) to be used for farming purposes.

Exceptions

The limit on using bond proceeds for land acquisition does not apply to any qualified mortgage bond, qualified veterans' mortgage bond, qualified student loan bond, qualified 501(c)(3) bonds, an exempt facility bond for qualified public-private schools or qualified redevelopment bonds (blighted areas).[199] If the land is acquired for noise abatement, wetland preservation or for the future use of an airport, mass commuting facility, high-speed intercity rail facility, dock or wharf, and there is no other significant use of such land, then the restriction does not apply to land acquired by a governmental unit in connection with an airport, mass commuting facility, high-speed intercity rail facility, dock or wharf.[200] Further, if certain

[199] Secs. 144(c)(8), 147(h)(1), 147(h)(2), and 147(h)(3).

[200] Sec. 147(c)(3)(A).

requirements are met, the limit on land acquisition does not apply to land to be used for farming purposes by a first-time farmer who will materially and substantially participate in the operation of the farm.[201]

Description of Proposal

The proposal increases the 25 percent land acquisition restriction to 35 percent on certain qualified private activity bonds (i.e., those qualified private activity bonds not currently excluded from the 25 percent land restriction).

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

Analysis

Present law provides that, for private activity bonds, the acquisition of land cannot constitute 25 percent or more of the use of the net proceeds of a bond issue. The restriction currently applies to the following:

- certain exempt facility bonds:
- facilities for the furnishing of water;
- sewage facilities;
- solid waste disposal facilities,
- qualified residential rental projects,
- facilities for the local furnishing of electric energy or gas;
- local district heating or cooling facilities;
- qualified hazardous waste facilities; environmental enhancements of hydroelectric generating facilities;
- qualified green building and sustainable design projects (authority to issue expired September 30, 2012);
- qualified highway or surface freight transfer facilities, and
- qualified small issue bonds (relating to manufacturing and first time farmers).

The restriction was added to the 1954 Code in 1984 and recodified in 1986 in substantially the same form with modifications to the rules affecting farmers. The legislative history for the 1984 addition does not specifically expound upon the reasons for the restriction. The limit on land acquisition was among several limitations on private activity tax-exempt bonds added by the 1984 Act, including the limit on the acquisition of existing facilities, and the tightening of arbitrage restrictions. At the time, Congress was concerned with the rapid growth

[201] Sec. 147(c)(2).

in the volume of tax-exempt bonds for private activities.[202] One might surmise that Congress intended the land acquisition restriction to ensure that the bulk of subsidized financing be used for constructing the approved categories of facilities rather than the acquisition of relatively expensive land upon which the facilities are to be built. A higher limitation may encourage the overbuying of land not being put to immediate use. One could argue that it is the activity, rather than the land, that will add most to employment, either in the form of construction jobs or employment at the facility.

Some may argue that the current 25 percent limitation does not reflect that the acquisition of land has become a larger component of the total cost of certain projects and that otherwise worthwhile capital projects may not get built due to the acquisition of land limitation. For example an increase to 35 percent may make sense for highway projects, which may require additional land acquisition and right of ways to complete.

Proponents of the increase in the limitation from 25 percent to 35 percent may argue that it still requires a substantial portion of the bond proceeds to be devoted to constructing the facility. Opponents may argue that since the restriction is expressed in terms of a percentage, the inflationary value of land is kept in proportion to the facility to be constructed and an increase is not warranted.

[202] S. Rept. No. 98-169, Vol. 1, p. 696.

F. Allow More Flexible Research Agreements for Certain Tax-exempt Bond-Financed Property

Present Law

In general

Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt governmental bonds to finance a broad range of projects. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the parties that may benefit from such financing. For example, present law limits the amount of governmental bond proceeds that can be used by nongovernmental persons. Use of bond proceeds by nongovernmental persons in excess of amounts permitted by present law may result in such bonds being treated as taxable private activity bonds, rather than tax-exempt governmental bonds. The Code does not expressly define a governmental bond. Instead it defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test") or (2) the private loan financing test.[203] Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

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

Private business test

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

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

2. more than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, (a) secured by property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[204]

A bond is not a private activity bond unless both parts of the private business test (i.e., the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity

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[203] Sec. 141.

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

bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not paid by the factory owner or other private parties.

In general, private business use arises when a private business owns or leases tax-exempt bond financed facilities or otherwise has legal rights to the beneficial use of such facilities. A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use depending on the terms of the contract.[205] In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits.[206] For example, a management contract with respect to a commuter rail facility that compensates the management company based on the profits of such facility would result in private use. Contracts for service incidental to the facility's primary functions, such as janitorial, office equipment repair, and similar services, are not considered management contracts.

For purposes of the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.[207]

Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

Qualified private activity bonds

In general

Qualified private activity bonds are tax-exempt bonds issued to provide financing for specified privately used facilities. "Qualified private activity bond" means an exempt facility

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

[206] In addition to net profits, there are other indicia of private business use involving management contracts. A management agreement for a tax-exempt bond financed facility that does not meet the safe harbor provisions of Rev. Proc. 97-13, 1997-1 C.B. 632 as amended by Rev. Proc. 2001-39, 2001-2 C.B. 38 may result in private business use of the facility by the manager.

[207] Treas. Reg. sec. 1.141-4(c)(2)(C).

bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, section 501(c)(3), or student loan bond.[208]

Qualified 501(c)(3) bonds

State and local governments may issue tax-exempt bonds to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds"). The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) may be financed with qualified 501(c)(3) bonds. Qualified 501(c)(3) bonds are not subject to the State volume cap.

Research agreements

The legislative history to the Tax Reform Act of 1986[209] provided two safe-harbors under which 501(c)(3) organizations could arrange cooperative research agreements with non-governmental parties. The General Explanation of the Tax Reform Act of 1986[210] provides:

> First, a university facility may be used for corporate-sponsored research as long as any license or other use of the resulting technology by the sponsoring party is permitted only on the same terms as the university would permit such use by any nonsponsoring unrelated party; that is, the sponsor must pay a competitive price for its use of the technology. Thus, the sponsoring university is not actually required to grant use of the technology to any other party; however, the sponsoring party must pay a price for any use of any resulting technology that is the same as a nonsponsoring party would pay. Further, that price must be determined at the time the technology is available for use rather than at an earlier time (*e.g.,* when the research agreement is entered into).
>
> Second, facilities used pursuant to joint industry-university cooperative research agreements may be eligible for tax-exempt financing where, as under most such arrangements currently sponsored by the National Science Foundation --
>
> (1) multiple, unrelated industry sponsors agree to fund university-performed basic research;
>
> (2) the research to be performed and the manner in which it is to be performed is determined by the university;

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[208] Sec. 141(e).

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

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

(3) title to any patent or other product incidentally resulting from the basic research lies exclusively with the university; and

(4) sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any such research.

Congress further understood that section 501(c)(3) universities may enter into cooperative arrangements similar to those described in the preceding two paragraphs and intended the same rules to apply in determining whether proceeds of bonds for these organizations are used in a private business use."

These rules covering corporate-sponsored basic research and industry or Federally-sponsored basic research are currently embodied in Rev. Proc. 2007-47. To summarize, for corporate-sponsored research, the sponsor must pay a competitive price for the use of the technology (i.e. no less than what would be paid by an unrelated non-sponsoring party for the same use at the time the license or technology is available for use). For industry-sponsored research if the following four requirements are met: (1) single or multiple sponsors agree to fund governmentally performed research; (2) the qualified user (State or local government or section 501(c)(3) organization) determines the research to be performed and the manner in which it is to be performed; and (3) title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and (4) the sponsor or sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research. The revenue procedure defines "basic research" as any original investigation for the advancement of scientific knowledge not having a specific commercial objective.[211] Product testing supporting the trade or business of a specific nongovernmental person is not basic research.

If the research agreement meets the guidelines of Rev. Proc. 2007-47, the research agreement will not result in private business use. Both private business use and private payment are required for a bond to be classified as a private activity bond as opposed to a tax-exempt governmental bond. If classified as a private activity bond, the bond must be a qualified private activity for the interest on such bond to be tax-exempt. There is no qualified private activity bond for privately-sponsored research.

Description of Proposal

The proposal provides 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) organization) is required to own the research facilities; and

(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

[211] Rev. Proc. 2007-47, par. 3.01 (definition of basic research), 2007-29 I.R.B., June 26, 2007.

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.

Effective date.−The proposal is effective for research agreements entered into after the date of enactment.

Analysis

As noted above, one of the key components to a research agreement not triggering private business use is that the sponsor pay a competitive price for the license/resulting technology and that such price be determined at the time the technology becomes available for use. The proposal allows the parties to enter into a pricing agreement prior to the technology becoming available for use. Some would argue that since the research is basic, meaning an original investigation, the value of any technology that might be developed from that research is unknown until the technology is available for use. The facts and circumstances that assist in the proper valuation of such technology may not be available if the contractual arrangement for its use is made well before the technology is available. Thus, any value agreed upon is speculative and possibly significantly undervalued. Thus the sponsoring party not only receives the benefit of tax-exempt subsidized financing, but also receives a bargain price for the license of the resulting technology.

Although the proposal would require that the State or local government or section 501(c)(3) organization own the property, the rule does not preclude the license from being an exclusive license to the sponsoring party. As a result, the sponsoring party, by negotiating well in advance, may receive a bargain price when viewed in hindsight and be able to exclude similarly situated businesses from taking advantage of the technology, creating an unfair competitive advantage.

On the other hand, some argue that the parties should be free to negotiate an arms-length deal on terms the parties find acceptable. Some may argue that the presence of the Federal subsidy means that the arrangement is not purely dictated by the marketplace and so some restrictions on the use of the resulting benefits to ensure proper use of a public good is warranted.

Some argue that more flexibility may encourage more basic research. However, the Code contains several mechanisms already to encourage research, such as the research credit[212] and expensing provisions that are available to all businesses engaged in such activities, not just those selected by a State or local government to benefit from tax-exempt financing.

[212] While the research credit is an expiring provision, making the research credit permanent is one of the FY 2014 budget proposals. See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals*, April 2013, p. 13.

G. Repeal the Government Ownership Requirement for Certain Types of Private Activity Bonds

Present Law

In general

Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[213]

Exempt facility bonds

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[214] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); qualified residential rental projects; privately owned and/or operated utility facilities (water, sewage, solid waste disposal, certain private electric and gas facilities, local district heating and cooling facilities, qualified hazardous waste facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building, and sustainable design projects.[215]

Airports

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

Port facilities

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

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[213] Sec. 141(e).

[214] Sec. 142(a).

[215] Sec. 142(a).

Mass commuting facilities

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

Description of Proposal

The President's proposal eliminates the requirement that airports, port facilities, and mass commuting facilities be owned by a governmental unit to qualify for tax-exemption under the exempt facility bonds rules.

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

Analysis

The present-law government-ownership requirement permits the Federal subsidy of the finance to these types of facilities while still providing flexibility for government owners to contract for private entities to operate and manage them. Repealing the governmental ownership requirement allows the private owners of these facilities to claim depreciation deductions on the property in addition to benefiting from subsidized tax-exempt bond financing.[216] This modification would facilitate more public-private partnerships between State and local governments, which may help the fiscal condition of these governments.

Government ownership may provide more direct oversight of these facilities to help ensure that the facilities are operated in the public interest. Relaxing the government ownership requirement might have some offsetting effects.

Furthermore, when the private activity bond volume cap limitations were enacted, exempt facility bonds for airports, docks and wharves, and certain solid waste disposal facilities were not subject to those limitations in part because all property financed with such bonds must be governmentally owned.[217] If the governmental ownership requirement is removed, it may be appropriate to subject financing for such property to the private activity bond volume cap.

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[216] Under present law, the private owners may depreciate the property under the alternative depreciation system ("ADS") rather than under the modified accelerated cost recovery system ("MACRS"). ADS generally allows longer depreciable lives and a straight-line method rather than the shorter lives and accelerated methods available under MACRS.

[217] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 1196.

H. Exempt Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act

Present Law

FIRPTA

In general

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources.[218]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[219] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[220] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of amounts that FIRPTA treats as effectively-connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment. Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[221] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

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[218] Secs. 871(b), 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time if sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6).

[219] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

[220] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[221] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and stock of a domestic U.S. real property holding company ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during the shorter of the taxpayer's ownership of the stock or the five-year period ending on the date of disposition of the stock.[222] However, any class of stock that is regularly traded on an established securities market is treated as a USRPI only if the seller held (applying attribution rules) more than five percent of the stock at any time during such period.[223]

Under these rules, if a foreign person directly owns U.S. real property, or owns U.S. real property through a partnership, gain from the sale of the real estate will be subject to tax as FIRPTA income.[224] Alternatively, if a foreign person owns U.S. real property through a corporation that is a USRPHC that is not publicly traded (or owns more than five percent of the stock of a publicly traded USRPHC during the relevant period), gain from sale of the corporate stock generally is subject to tax as FIRPTA income.

Foreign investment through REITS and RICs

Special rules apply to foreign investment through a REIT or through certain RICs that invest largely in U.S. real property interests (including stock of a REIT). A foreign investor may invest in such entities without subjecting the investor to FIRPTA, to a greater degree than if the investment were made directly or through a partnership.

For example, if such an entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant holding period), a foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA.[225] Also, if a foreign investor has owned no more than 5 percent of a class of stock of such an entity that is regularly traded on an established securities market located within the U.S., during the one year period ending on the

[222] Secs. 897(c)(1)(A)(ii) and 897(c)(2).

[223] Sec. 897(c)(3). Constructive ownership rules apply under section 897(c)(6)(C).

[224] See also, Rev. Rul. 91-32, 1991-1 C.B. 107.

[225] A "qualified investment entity" means any REIT. It also includes, for purposes of the special rules, any RIC which is a USRPHC or which would be a USRPHC if the exceptions provided in sections 897(c)(3) (regarding five-percent shareholders of publicly traded entities) and 897(h)(2) (regarding domestically controlled entities) did not apply to interests in any RIC or REIT. After December 31, 2013, a RIC is not included in the definition for purposes of the rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

date of the distribution, then amounts attributable to gain from entity sales of USRPIs can be distributed to the foreign investor without being subject to FIRPTA tax.[226]

Apart from that rule, a distribution by a REIT or RIC to a foreign shareholder, to the extent attributable to gain from the entity's sale or exchange of USRPIs, generally is treated as FIRPTA income to the shareholder. The FIRPTA character also is retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[227] An IRS notice states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to both nonliquidating and liquidating distributions to a qualified investment entity shareholder and that the IRS will issue regulations to that effect.[228]

U.S. retirement plans and investment in U.S. real property

Subject to various requirements, certain U.S.-based employer-sponsored retirement plans receive tax-favored treatment, including qualified retirement plans.[229] Tax-favored treatment generally requires that the plan provide benefits to a broad group of employees, rather than only highly-compensated employees, that various employee protections are provided, such as the vesting of benefits after a specified period of service, and that plan assets be held in a trust or other fund for the exclusive benefit of participants. Trusts and other funds holding the assets of these plans (referred to herein as "U.S. pension funds") generally are exempt from Federal income tax. Individual retirement accounts ("IRAs") also are exempt from Federal income tax.[230]

A U.S. tax-exempt organization (including a U.S. pension fund or an IRA) nevertheless is subject to tax on income from a trade or business that is not substantially related to its exempt function (unrelated trade or business income, or "UBTI").[231] Under the relevant definitions of

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[226] Such distributions that are dividends are subject to withholding tax as dividends, but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions that are not dividends are not subject to tax under FIRPTA. AM 2008-003, February 15, 2008.

[227] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[228] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

[229] Sec. 401(a). Other types include qualified annuity plans under section 403(a), tax-deferred annuity plans under section 403(b), eligible deferred compensation plans of governmental employers under section 457(b), and certain pension plans funded only by employee contributions under section 501(a)(18).

[230] Sec. 408(e)(1).

[231] Secs. 511-514.

these terms, a U.S. tax-exempt organization generally may receive rents from real property without tax, provided certain requirements are met regarding the extent of personal property leased with the real property and provided the activities of the organization with respect to the property do not amount to the provision of services to the occupant primarily for his convenience and other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.[232] A U.S. tax-exempt organization also is permitted to receive gains from the sale of property without tax, provided the property is not inventory or other property held for sale to customers in the ordinary course of business.[233]

The exceptions from UBTI for rents and gain do not apply to the extent the property rented or sold is debt-financed.[234] A U.S. tax-exempt organization that directly owns U.S. real property (or that owns a partnership interest in a partnership that owns such property) generally is subject to unrelated business income tax on income or gain from the property (including real property), to the extent the property is debt-financed.[235] However, exceptions apply in the case of certain organizations, including qualified retirement plans and certain retirement accounts, provided that requirements relating to the debt, the purchase price, and payments of rents only from unrelated parties are satisfied.[236] If the requirements are met, such U.S. tax-exempt organizations can receive rents and gains on sale of debt-financed real property without tax.

A tax-exempt organization (including a U.S. pension fund) can generally own stock of a REIT and not be treated as receiving UBTI if the REIT engages in activities that would generate UBTI. However, if a trust holding assets of a qualified retirement plan owns more than 10 percent by value of the interests in a "pension-held REIT," such trust is treated as having a proportionate amount of gross income from an unrelated trade or business with respect to dividends it receives from the REIT.[237]

Description of Proposal

The proposal exempts 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

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[232] Sec. 512(b)(3); Treas. Reg. sec. 1.512(b)-1(c)(5).

[233] Sec. 512(b)(5). Certain gain from timber cutting that is treated as gain from a sale or exchange of property under section 631 is not within the scope of the exception from unrelated trade or business income. See Treas. Reg. sec. 1.512(b)-1(d) and PLR 8520132, interpreting section 512(b)(5), which does not allow a tax-exempt organization that directly holds timberland or that holds it through a partnership to exclude from UBTI any gain from timber cutting that is treated as capital gain sales income under section 631. The regulations state that section 631(a) income of the taxpayer from its own cutting of timber is UBTI. The PLR concluded that income under section 631(b) was not UBTI.

[234] Secs. 512(b)(4) and 514.

[235] Sec. 514.

[236] Sec. 514(c)(9).

[237] Sec. 856(h)(3).

generally means a trust, corporation, or other organization or arrangement that (1) is created or organized outside the United States; (2) is generally exempt from income tax in the jurisdiction in which it is created or organized; and (3) substantially all of the activity of which is to administer or provide pension or retirement benefits. The Secretary is 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.

Effective date.−The proposal is effective for dispositions of U.S. real property interests occurring after December 31, 2013.

Analysis

FIRPTA compared to other rules causing effectively connected income

FIRPTA was enacted in 1980. The legislative history indicates a concern that foreign investors could own and operate U.S. real estate, claiming to be engaged in U.S. trade or business during the operational and ownership phase so that depreciation and other tax benefits could offset taxable rent or other income, yet claiming not to be engaged in a U.S. trade or business at the time the property was sold or gain was reported, hence paying no U.S. tax on the gain at sale.[238]

In 1986, the rules relating to when property owned by a foreign person is considered used or held for use in connection with the conduct of a trade or business in the United States were modified for all property (not merely for real estate) to address two situations. First, if property is sold and gain reported on the installment method, then any gain reported after the year in which the property ceases to be used or held for use in connection with the conduct of a trade or business in the U.S. nevertheless is treated as gain from property so held if the property was so held at the time of the sale.[239] Second, if any property ceases to be used or held for use in connection with the conduct of a trade or business in the United States and such property is disposed of within 10 years after such cessation, the property is treated as so held at the time of sale.[240]

Property sold to a U.S. purchaser (or to a foreign purchaser that holds the property for use in connection with a U.S. trade or business) obtains a fair market value basis for depreciation and other purposes in measuring income from the property. To the extent property can be sold by a tax-exempt or other non-taxed person with the buyer obtaining a stepped up fair market value basis, there is a tax advantage to the situation.

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[238] Report of the Finance Committee of the Senate to accompany H.R. 1212, S. Rep. No. 96-532, December 19, 1979, p. 11; Report of the Committee on the Budget, House of Representatives to accompany H.R. 7765, H.R. Rep. No. 96-1167, July 21, 1980, p. 511.

[239] Sec. 864(c)(6).

[240] Sec. 864(c)(7).

The proposal exempts gain from the disposition of a USRPI by a foreign pension fund (as defined in regulations to be published by the Treasury Department) from U.S. tax under FIRPTA. The proposal does not appear to incorporate the requirement applicable to U.S. pension funds that sales not be of property held for sale to customers in the ordinary course of business. However, a foreign pension fund that sold real property held for sale to customers in the ordinary course of business likely would have U.S. effectively connected income without regard to FIRPTA.

The proposal does not appear to subject foreign pension funds to the UBTI regime, nor to incorporate any of the requirements that would have to be met with respect to debt-financed real estate in order for a U.S. pension fund to be free from tax under that regime on debt-financed income (including capital gain from the sale of the debt-financed real property). A foreign pension fund would generally be taxable on its income from rental of U.S. real property, and hence might not be considered a vehicle for engaging in the type of rent-sheltering transactions that generated the present law debt-financed income restrictions. However, to the extent that interest, together with other deductions, reduces taxable rental income significantly for any real estate owner, a question may remain whether gain from the sale of debt-financed real property should be exempt from tax only for certain foreign holders.

The proposal does not affect the non-FIRPTA rules of section 864(c) that can cause gain on a sale of property owned by a foreign person to be treated as gain effectively connected with the conduct of a trade or business in the United States. Foreign pension funds thus could still be concerned regarding the application of those rules. However, such funds might invest in U.S. real property through a REIT. The proposal does not describe any changes to the REIT rules under FIRPTA. If foreign pension funds are treated in the same manner as U.S. pension funds under those rules, then a foreign pension fund could own virtually all the stock or beneficial interests of a private REIT that owned U.S. real property, without the foreign pension fund being subject to tax under FIRPTA on the disposition of its REIT stock, or on the REIT's distribution of capital gains from the disposition of U.S. real property interests.[241] The REIT could presumably invest in U.S. real property, operate the property taking current deductions against rental income for depreciation, interest expense, and operating expenses, and then sell the property and distribute the proceeds to the pension fund without FIRPTA or other U.S. tax. In contrast, if a U.S. pension fund holding assets of a qualified retirement plan held more than 10 percent by value of the interests in a pension-held REIT, it would be exposed to unrelated business income tax (though not FIRPTA tax) if the REIT engaged in activities that would produce UBTI under the present law rules relating to a pension held REIT. As noted previously, however, the proposal does not appear to subject foreign pension funds to the UBTI regime.

[241] Under this approach, because the foreign pension fund would not be subject to FIRPTA, the requirement that REIT stock be "domestically controlled" in order for certain sales of that stock by foreign investors to be exempt from U.S. tax under FIRPTA would not apply. Similarly, any dividend or otherwise taxable distributions to the foreign pension fund by the REIT from the sale of U.S. real property interests would not be subject to FIRPTA tax.

Definition and identification of foreign pension plans eligible for the FIRPTA exemption

The stated rationale for the proposal is to treat foreign pension funds that may wish to invest in U.S. real property comparably with U.S. pension funds that are exempt from tax. Presumably the proposal is intended to encourage greater investment in real estate in the United States by foreign entities, though limited to pension funds. The proposal includes a general definition of foreign pension fund for this purpose. Such a fund is a trust, corporation, or other organization or arrangement that (1) is created or organized outside the United States; (2) is generally exempt from income tax in the jurisdiction in which it is created or organized; and (3) substantially all of the activity of which is to administer or provide pension or retirement benefits. Under the proposal, the Secretary also is granted authority to issue regulations addressing whether, for this purpose, an entity or arrangement is a foreign pension fund or a benefit is a pension or retirement benefit.

The proposal refers only to broad criteria to be considered to determine whether an entity is eligible for exemption from FIRPTA. Further statutory clarification of any constraints on the authorized Treasury Regulations might be considered. For example, the proposal does not specify how closely the criteria for foreign pension funds eligible for the exemption are expected to parallel the requirements applicable to U.S. pension funds that are exempt from Federal income tax, and does not specify whether the beneficiaries of the foreign pension fund may include U.S. persons. If the purpose of the proposal is to encourage foreign investment, it might be considered desirable to limit the extent to which the exempted foreign funds can be established to benefit U.S. persons, or otherwise to obtain more favorable U.S. tax treatment of U.S. real estate investment than if they had been established as U.S. pension funds. The proposal also is not clear whether a tax-exempt retirement arrangement for the benefit of a single individual (similar to an IRA) is intended to be eligible for the exemption. In addition, the proposal does not specify whether the foreign fund must satisfy any particular reporting or other requirements in the country in which it is established (which might be helpful if the exemption from FIRPTA is intended to apply only to certain situations). And it does not specify whether the fund must provide specific evidence, issued by the foreign government, of the fund's foreign tax-favored status. An overly broad definition of exempt foreign pension funds could result in disadvantaging U.S. pension funds, while a narrow definition might not encourage the apparent goal of encouraging foreign investment in U.S. real property.

Proponents of clarifying the scope of the exemption in order to guide the Secretary's regulatory authority may prefer an expanded statutory list of criteria, focusing on some or all of the issues noted above. Others may prefer addressing some of the criteria in the statute but leaving other elements to the discretion of the Treasury Department, perhaps with some guidelines regarding the policy to be achieved.

Some might also wish to consider looking to categories of foreign pension funds described in regulations under the Foreign Account Tax Compliance Act ("FATCA").[242] FATCA is a regime designed to encourage transparency of foreign financial accounts held by U.S.

[242] Secs. 1471-1474 and regulations thereunder.

persons, through information reporting to identify such U.S. holders (but not to prohibit U.S holders), and withholding where information is not provided. FATCA addresses a variety of types of foreign entities and institutions, and includes broad grants of regulatory authority. It does not specifically address the treatment of pension funds or retirement savings, but provides that payments to specific types of entities, including certain tax-exempts, as beneficial owner of the payments, are exempted from the withholding and reporting requirements, as are "any other class of persons identified by the Secretary for purposes of this subsection as posing a low risk of tax evasion."[243]

In the final regulations, the Secretary determined that retirement funds may be a class of persons presenting a low risk of tax evasion, if they fall within certain categories. The regulations identify the following six categories:

- a treaty-qualified fund established in a country with which the U.S. has an income tax treaty in force, provided that the fund is entitled to benefits under such treaty on income that it derives from sources within the U.S. (or would be so entitled if the fund derived any such income) as a resident of the other country that satisfies any applicable limitation on benefits requirement, and is operated principally to administer or provide pension or retirement benefits;
- a broad participation fund established to provide retirement, disability or death benefits to employees of one or more sponsors of the fund in consideration for services rendered, provided that no single beneficiary has a right to more than five percent of the fund, that the fund is subject to government regulation and provides annual information reporting about beneficiaries of the fund to the relevant tax authorities in the country in which the fund is established or operates, and the fund meets one or more conditions related to the source of its assets, its contributions, and the timing of distributions;
- a narrow participation fund established to provide retirement, disability or death benefits to employees in consideration for services rendered, provided that the fund has fewer than 50 participants, has limits on the extent to which nonresidents of the country in which the fund is organized may benefit, has limits on contributions to the fund, and requires both government regulation and annual information reporting about beneficiaries of the fund to the relevant tax authorities in the country in which the fund is established or operates;
- a fund that meets the requirements of a section 401 plan, other than the requirement to be created or organized in the United States;
- a fund that is an investment vehicle created exclusively for the retirement funds; and
- a pension fund of an exempt beneficial owner identified in the statute.[244]

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[243] Sec. 1471(f)(4).

[244] Treas. Reg. Sec. 1.1471-6(f)(1) through (6). In response to comments received on proposed regulations, each of the categories under these final regulations is determined without regard to whether or not the fund is the "beneficial owner" of the income (although the statutory provision for excepted payments refers to

Both broad and narrow participation funds must be government regulated and subject to annual information reporting to tax authorities with respect to beneficiaries in order to qualify.

Opponents of adopting exceptions from FATCA as a model for crafting exceptions from FIRPTA may note that because the goal of FATCA is transparency of U.S ownership, (as opposed to restrictions on any types of ownership), conclusions about FATCA exceptions may not be equally applicable to FIRPTA. The FATCA rules might be too broad or too narrow for the intended FIRPTA purposes, depending on the FIRPTA policy to be achieved. As one example, as noted above, if the purpose of the proposal is to encourage foreign investment, it is not clear whether individual retirement accounts or certain other plans covering U.S. individuals are intended to be permitted if established abroad, where they might obtain more favorable treatment with respect to U.S. real estate investment than a U.S. account or plan could obtain. Similarly, as another example, not all treaties contain the same levels of limitations on benefits, if that were considered important for the FIRPTA provisions.

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payments to "beneficial owners,"). See Preamble, Treas. Decision 9610, 26 C.F.R. Parts 1 & 301, 5873-5995, January 28, 2013, p. 88. Because the goal of FATCA is transparency to identify U.S. holders to the IRS, rather than the absolute prohibition of U.S holders, broadening the class may be harmless to the extent that the Secretary is satisfied that the funds are subject to government constraints and are utilized by foreign beneficiaries, and that information about the funds is likely to accessible.

PART XI − UPPER INCOME TAX PROVISIONS

A. Reduce the Value of Certain Tax Expenditures

Description of Modification

The fiscal year 2014 budget proposal modifies the prior year budget proposal by applying the 28-percent limitation on the value of the specified deductions or exclusions to all taxable income in the 33-percent, 35-percent, and 39.6-percent rate brackets. The fiscal year 2013 proposal applied only to taxable income in the 36 and 39.6 percent brackets in order to exempt taxable income in the 33-percent bracket, which in the 2013 budget proposal would have applied to certain taxpayers with AGI less than $200,000 ($250,000 in the case of a married joint return), adjusted for inflation after 2009.[245]

In addition, the proposal is modified to allow an adjustment to the taxpayer's basis to reflect the additional tax imposed if a deduction or exclusion for contributions to retirement arrangements is limited by this provision.

[245] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 219.

B. Implement the Buffett Rule by Imposing a New "Fair Share Tax"

Present Law

Under present law, individual taxpayers pay different average rates of tax based on the amount and composition of their income (*i.e.*, capital gains and qualified dividends, which receive preferential rates, or ordinary income, which is subject to regular tax rates), and the number and amount of deductions and credits for which they are eligible. Present law contains no "Fair Share Tax" designed to impose a minimum average rate of tax on upper income taxpayers. However, the Code does contain an alternative minimum tax ("AMT") that is imposed on an individual, estate, or trust. This AMT has the effect of offsetting some, but not all, of the Code's features that contribute to the lower average tax rate faced by some taxpayers.

The AMT calculates a taxpayer's tentative minimum tax, which is a taxpayer's taxable income increased by certain "preference items" and "adjustments," known as the alternative minimum taxable income ("AMTI"). The AMT is then imposed at a 26-and 28-percent rate on AMTI, less an exemption amount, which is indexed for inflation. A taxpayer pays the AMT to the extent that it exceeds the taxpayer's regular tax liability. Very generally, the "preference items" and "adjustments" by which taxable income is increased for purposes of computing AMTI include the standard deduction and personal exemptions, as well as the deduction for state and local taxes, miscellaneous itemized deductions, and various benefits related to accelerated depreciation and amortization.

Preferential rates for capital gains and qualified dividends are maintained under the AMT.

Description of Proposal

The proposal would impose a new minimum tax, in addition to the AMT described above, called the Fair Share Tax, imposed on certain high-income taxpayers. The amount of the tax would equal the excess (if any) of a taxpayer's tentative Fair Share Tax for the taxable year over the sum of the taxpayer's (a) regular tax liability (less allowable credits except for the foreign tax credit), (b) alternative minimum tax, and (c) payroll tax, where the payroll tax includes the employee's share of the OASDI and HI portions of FICA taxes, the additional 3.8-percent tax on net investment income, and any self-employment taxes less the deduction for self-employment taxes permitted under section 164(f) of the Internal Revenue Code ("Code").

The taxpayer's tentative Fair Share Tax equals 30 percent of the taxpayer's adjusted gross income ("AGI") less a credit for charitable contributions. The charitable credit equals 28 percent of itemized charitable contributions allowed, after the application the overall limitation of itemized deductions under section 68 of the Code.

The Fair Share Tax is phased in starting at $1 million of AGI ($500,000 in the case of a married individual filing a separate return), and is fully phased in at $2 million of AGI ($1,000,000 in the case of a married individual filing a separate return).

Analysis

The premise of the proposal is that high-income taxpayers often pay lower average rates of tax compared with lower-income taxpayers, by availing themselves of various deductions, credits and exclusions, and because a larger share of their income is derived from capital gains and qualified dividends, which are taxed at preferential rates. This may especially be the case when one includes within the calculation of the average tax rate the employee's share of the OASDI portion of FICA taxes, because this tax is imposed only on the first $113,700 of wages.[246] For example, in 2013 a single taxpayer with $80,000 of wage income who takes the standard deduction would owe $13,429 in Federal income taxes, and $6,120 in payroll taxes, for a total tax liability of $19,549. This amounts to an average tax rate of 24.44 percent. By contrast, a single taxpayer with no dependents whose sole income consisted of qualified dividends and capital gains of $2,000,000 (assuming no itemized deductions) would pay Federal tax of $441,742.50,[247] an average tax rate of 22.1 percent. The proposal would subject the second taxpayer to the Fair Share Tax, increasing that taxpayer's tax liability by $158,257.50, to bring that taxpayer's average tax rate to 30 percent.

Proponents of the Fair Share Tax may argue that the current tax code, because of the preferential rates for capital gains and qualified dividends, and the exclusions and deductions that disproportionally benefit high-income taxpayers, can often produce outcomes wherein higher-income taxpayers pay lower rates of tax, on average, than lower-income taxpayers. Proponents of the proposal may argue that the Fair Share Tax improves both the horizontal and vertical equity of the tax code.

In the context of an income tax system, horizontal equity means that taxpayers with similar incomes pay similar amounts of tax, while vertical equity means taxpayers with higher incomes pay more tax. The Fair Share Tax could promote horizontal equity by equalizing the average rate of tax paid by high-income taxpayers. Under present law, a high income taxpayer whose income consists solely of ordinary income will have an average rate of tax that approaches 39.6 percent. A high income taxpayer whose income consists solely of capital gains and qualified dividends will have an average tax rate that approaches 23.8 percent. The Fair Share Tax would require the latter taxpayer to pay additional tax such that his average tax rate is 30 percent. Proponents may argue that by increasing this taxpayer's average rate of tax, the Fair Share Tax works to counteract those provisions of the tax code that violate the principle of horizontal equity.

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[246] Additionally, most economists agree that the incidence of the employer portion of social insurance taxes falls on the employee. Including this amount in the average tax rate increases the differential between the average tax rate of those individuals who are targeted by the Fair Share Tax and those for whom most, if not all, of their income is below the OASDI cap of $113,700.

[247] $2,000,000 less the standard deduction is $1,993,900 (the taxpayer's personal exemption is phased out at this AGI). The first $36,250 of income is taxed at 0 percent, the next $363,750 is taxed at 15 percent, and the remaining $1,593,900 is taxed at 20 percent. An additional 3.8 percent tax on net investment income on investment income exceeding $200,000 applies, adding $68,400 to the taxpayer's total tax.

As shown in the example above, present-law tax rules can result in violations of vertical equity. Proponents may argue that violations of vertical equity are particularly important to remedy, as our income tax system is designed to be progressive. A progressive income tax is a tax system whose design is such that higher-income taxpayers pay higher average rates of tax than lower-income taxpayers. Underlying such a system is the notion that taxes should be levied based on an individual's ability to pay. A tax system that produces results wherein a higher-income individual pays a lower average rate of tax than a lower-income individual levies a greater burden on those with less ability to pay the tax. Proponents may argue that the Fair Share Tax ensures that the principle of vertical equity will not be violated in the case of low and middle-income taxpayers, as compared with high-income taxpayers whose average tax rate is well below 30 percent.

Opponents of the Fair Share Tax may argue that, to the extent the Fair Share Tax seeks to claw back some or all of the tax benefits that accrued to the high-income taxpayers to whom the Fair Share Tax applies, it does so at the expense of the very rationale that prompted Congress to enact those policies. For instance, proponents of preferential rates on capital gains have argued that such a policy promotes the efficiency of capital markets, a more socially optimal level of risk taking, and long-run economic growth.[248] If the Congress still believes that preferential rates on capital gains have these positive effects, then logically the Fair Share Tax would serve to counteract these effects. This is especially true to the extent that a large portion of capital gains income is concentrated within the population that would be affected by the Fair Share Tax.

Related to this, opponents may also argue that, to the extent the Fair Share Tax effectively reduces a taxpayer's itemized deductions (i.e., all itemized deductions other than the deduction for charitable donations), it is undoing provisions of the tax code that are meant to properly measure a taxpayer's ability to pay tax. For instance, a high-income taxpayer who lives in a high-tax State may pay well over 10 percent of his or her income in State and local income and property taxes, all of which are deductible as an itemized deduction. A rationale commonly invoked to support the deduction for State and local taxes is that such taxes amount to resources claimed by the State and local government; these amounts are unavailable to the taxpayer and are thus inappropriate to include within the Federal tax base. Opponents may argue that the Fair Share Tax needlessly creates a differential in the measure of taxpayers' tax bases, improperly measuring the high-income taxpayer's ability to pay tax.[249]

Opponents of the Fair Share Tax may also argue that the premise underlying the Fair Share Tax is incorrect in that it measures a taxpayer's average tax rate with respect to that taxpayer's total tax paid. Specifically, opponents may argue that it is inappropriate to include the employee's portion of the OASDI and HI taxes within the average tax calculation. Although it is true that these are taxes paid by individuals, opponents may argue that the benefit received by the

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[248] For a complete discussion of the arguments for and against a capital gains rate differential, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 210.

[249] Another example of this is in the context of the deduction for investment interest, which, despite being an itemized deduction, is widely recognized as a necessary component in determining a taxpayer's tax base.

individual in the form of Social Security benefits makes such taxes more akin to social insurance premiums rather than income taxes as they are traditionally understood. Opponents may argue that lower-income individuals generally receive more benefit from Social Security payments relative to their contributions, as compared with higher-income taxpayers, making the inclusion of the employee portion of the OASDI and HI taxes within the average tax rate a misleading comparison. For instance, in the example above, if one were to exclude the $80,000 earner's payroll taxes from the average tax calculation, that individual would have paid only 16.79 percent of his income in Federal income taxes. Opponents may argue that this is a more appropriate measure of the tax code's burden.

Finally, opponents may argue that the Fair Share Tax needlessly complicates the tax code. Under present law, a taxpayer must compute his or her tax twice: once under the regular income tax and once under the AMT. The Fair Share Tax would require taxpayers to undergo a third tax calculation. Opponents might suggest that such a third calculation is unnecessarily complicated, and that if the Congress wished to claw back the various tax benefits that have lead to reduced income tax rates, it could do so more directly (such as by raising the rate on capital gains for high-income taxpayers).

PART XII − MODIFY ESTATE AND GIFT TAX PROVISIONS

A. Restore the Estate, Gift, and Generation-Skipping Transfer ("GST") Tax Parameters in Effect in 2009

Description of Modification

The proposal, in part, reduces the estate and gift tax applicable exclusion amounts from present-law levels. The fiscal year 2013 budget proposal is modified by clarifying that, in computing estate and gift tax liabilities, no estate or gift tax is incurred by reason of such reductions with respect to a prior gift that was excluded from gift tax at the time of the transfer (when the applicable exclusion amounts were higher).[250]

In addition, the fiscal year 2013 budget proposal is modified by delaying the effective date. The fiscal year 2014 budget proposal is effective for estates of decedents dying, and for transfers made, after December 31, 2017.

[250] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 75-76.

B. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

Description of Modification

The fiscal year 2013 budget proposal is modified in certain respects.[251] First, the proposal is narrowed so that the transfer tax consequences of the proposal apply only in situations in which 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.[252] Although this narrowing of the proposal likely mitigates the potential concerns about the breadth and uncertainty of the intended scope of the proposal described in the Joint Committee staff's analysis of the 2013 budget proposal, certain of those concerns may still exist under the narrowed proposal.

Second, the fiscal year 2013 budget proposal is modified to add new exceptions. The modified proposal does not apply, for example, 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 (generally, "rabbi trusts").

In addition, the modified proposal does not apply to "any trust that is a grantor trust solely by reason of section 677(a)(3)." Under section 677(a)(3), a grantor generally is treated as owner of a trust for income tax purposes, if the income of the trust may be used to pay the premiums on insurance policies on the life of the grantor or the grantor's spouse. This final exception appears to be intended to exclude irrevocable life insurance trusts from the reach of the proposal. Assuming this is the goal of the exception, the exception as described may be both overbroad and under-inclusive. For example, a trust that is a grantor trust "solely" by reason of trust language permitting the use of income to pay premiums on a life insurance policy may not actually be used as a life insurance trust. In other words, the exception may be overbroad by excluding from the reach of the provision certain trusts that are not used as insurance trusts, but qualify for grantor trust status by reason of section 677(a)(3). In addition, a trust that is used only as a life insurance trust may be treated as a grantor trust by being described both in section

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[251] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 83.

[252] The fiscal year 2013 budget proposal, in contrast, is not limited to situations in which such a transaction has occurred.

The potential transfer tax consequences under the proposal are that 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 (1) subject to estate tax as part of the gross estate of the deemed owner; (2) 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 (3) 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 distribute) during the life of the deemed owner.

677(a)(3) and in a separate provision of the grantor trust rules. Such a trust presumably would not qualify for the new exception, because it is not treated as a grantor trust "solely by reason of section 677(a)(3)." In this respect, the exception may be under-inclusive.

C. Clarify Generation-Skipping Transfer (GST) Tax Treatment of Health and Education Exclusion Trusts (HEETS)

Present Law

Generation-skipping transfer tax rules

In general

Present law imposes transfer taxes designed to tax transfers of wealth once each generation. Taxes on transfers are imposed in the form of gift tax on lifetime transfers, estate tax on transfers at death, and generation-skipping transfer tax on gifts and bequests made to persons more than one generation younger than the transferor. Generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a skip person.[253] Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.[254]

The transferor generally is the individual who transfers property in a transaction that is subject to Federal estate or gift tax. A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (*e.g.*, grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

Generation-skipping transfer tax generally does not apply to lifetime gifts of a present interest in property up to the annual exclusion amount,[255] or to certain transfers for educational or medical expenses. A transferor is entitled to a generation-skipping transfer tax exemption, equal to the estate tax applicable exclusion amount, which may be allocated to transfers made by the transferor either during the transferor's life or at death. The exemption amount for 2013 is $5.25 million.

The tax on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the inclusion ratio. The maximum estate and gift tax rate for 2013 is 40 percent.

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[253] Sec. 2601.

[254] Sec. 2611.

[255] For 2013, the annual exclusion amount is $14,000.

The inclusion ratio with respect to any property transferred in a generation-skipping transfer is a function of the amount of generation-skipping transfer tax exemption allocated to a trust. The allocation of generation-skipping transfer tax exemption effectively reduces the tax rate on a generation-skipping transfer. The inclusion ratio is defined as one minus the applicable fraction.[256] The applicable fraction is a fraction the numerator of which is the generation-skipping transfer tax exemption allocated to the trust (or the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip) reduced by Federal and State estate and death taxes attributable to such property actually recovered from the trust (or transferred property) and any charitable deduction allowed.

In the case of a generation-skipping transfer trust, the exemption shields from the generation-skipping transfer tax distributions from, and terminations of interests in, the applicable fraction of the trust. Thus, if a generation-skipping transfer trust is created in 2013 with $5.25 million and $5.25 million of the transferor's generation-skipping transfer exemption is allocated to the trust, the inclusion ratio is zero, and no generation-skipping transfer tax is imposed on distributions from, or taxable terminations of interests in, that trust regardless of the number of generations of the trust's beneficiaries that are skipped, or the amount of appreciation accumulated in the trust. Alternatively if none of the transferor's generation-skipping transfer tax exemption is allocated to the trust, the inclusion ratio is one, and generation-skipping transfer tax at the maximum rate is imposed on taxable distributions and taxable terminations.

Exclusion of Certain Transfers for Education or Medical Expenses

The generation-skipping transfer tax does not apply to certain direct transfers for educational or medical expenses, "which, if made inter vivos by an individual," would not be treated as taxable gifts for gift tax purposes.[257] Certain transfers for educational or medical expenses are not considered transfers of property by gift for gift tax purposes.[258] This exclusion covers amounts paid on behalf of an individual as tuition directly to an educational organization[259] for the education or training of such individual or directly to any person providing medical care with respect to such individual.[260] The gift tax exclusion applies only to direct transfers to the educational institution or medical service provider, not to reimbursements to donees for amounts paid by them for otherwise qualifying services, or to trusts to provide for

[256] Sec. 2642.

[257] Sec. 2611(b)(1).

[258] Sec. 2503(e).

[259] In order to qualify for this exclusion, the transfer must be made to an educational organization described in section 170(b)(1)(A)(ii) (*i.e.*, an institution that normally maintains regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on).

[260] The definition of medical care for these purposes is found in section 213(d).

the education or medical care of designated beneficiaries.[261] This exclusion applies without regard to the relationship of the donor and donee.

Thus, payments made on behalf of a person two or more generations below the transferor for qualifying educational or medical expenses that are not taxable gifts for gift tax purposes will not be subject to the generation-skipping transfer tax.

Health and Education Exclusion Trusts ("HEETS")

A health and education exclusion trust ("HEET") is a trust set up to pay medical and tuition expenses of skip persons while avoiding generation-skipping transfer taxes.[262] A HEET can be funded either during a taxpayer's life through gifts to trust, or by the testamentary creation of a trust. These trusts generally include at least one beneficiary at all times who is not a skip person. Often, this one beneficiary is a charitable beneficiary. A charity is not a skip person, as it is considered to be in the same generation as the grantor. Thus, the transfer of assets to the trust is not subject to the generation-skipping transfer tax as a direct skip, and the termination of that beneficiary's interest in the trust is not a taxable termination.

The inclusion of a charity as a trust beneficiary is used to create a perpetual dynasty trust to avoid the generation-skipping transfer tax for numerous generations. A trust with a charitable beneficiary will not be considered a skip person for so long as the charity exists.[263] Often the trustee is given the power to appoint another charity as beneficiary should the original charitable beneficiary cease to operate or to qualify as a charity. Thus, the trust can survive for an indefinite and generally unlimited number of years into the future without the generation-skipping transfer tax applying.

These trusts are designed to avoid generation-skipping transfer tax by making distributions directly to educational institutions or to a medical care provider for educational expenses and medical care with respect to the trust beneficiaries.

Description of Proposal

The proposal clarifies the definition of section 2611(b)(1) relating to the exclusion from the generation-skipping transfer tax of certain payments for educational or medical expenses. Under the proposal the exclusion would apply only to payments made directly from the donor, while living, to a provider of medical care or to a school for payment of tuition. The exclusion would no longer apply to trust distributions for these purposes.

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[261] Treas. Reg. sec. 25.2503-6(c), ex. 2.

[262] See Wendy S. Goffe, "Oddball Trusts and the Lawyers Who Love Them or Trusts for Politicians and Other Animals," *American Bar Association Real Property, Trust & Estate Law Journal*, vol. 46, Winter 2012, p. 543, for a description of health and education exclusions trusts.

[263] To be considered a valid beneficiary a tangible amount of the trust corpus and income must be available for the benefit of the charity. Generally, this entails a yearly donation and some benefit to the charity upon termination of the trust.

Effective date.−The proposal is effective for trusts created after the introduction of the bill proposing the change, and to transfers after that date made to pre-existing trusts.

Analysis

Many practitioners take the view that under section 2611(b)(1), payments made from a trust for the benefit of the skip person are not subject to the generation-skipping transfer tax if made directly for qualifying educational and medical expenses.[264]

The Administration views the position taken by practitioners as an incorrect interpretation of the section 2611(b)(1) statutory language, arguing that the intent of the section is to exempt from generation-skipping transfer tax only those 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.

Practitioners argue that the statutory language of 2611(b) is only applicable to a distribution from a trust as the statute identifies "any transfer *which, if made inter vivos by an individual*, would not be treated as a taxable gift . . ."[265] The statute does not apply to *inter vivos* transfers made by an individual as the Administration argues; rather it applies to transfers that would have been exempt if such transfer were made by an individual. They further argue that section 2611(b)(1) is not needed to exclude gifts made by living individuals as such gifts are already excluded under section 2642(c). Thus, if section 2611(b)(1) applied only to transfers made by individuals, it is unnecessary.

The Administration argues that the use of a HEET allows substantial amounts transferred to the trust to appreciate with no estate, gift, or generation-skipping transfer tax after the initial funding of the trust. Under the proposal payments made by a trust for qualifying medical and educational expenses would not be excluded from the generation-skipping transfer tax. The proposal would eliminate the ability of grantors to use dynasty trusts to pay medical expenses and educational tuition of future beneficiaries while avoiding the generation-skipping transfer tax.

Others argue that the proposal does nothing to address the Administration's concern that these trusts may accumulate wealth for several generations without incurring generation-skipping tax as the proposal is aimed at taxing certain distributions rather than targeting the use of non-skip beneficiaries. If the trust continues to have a charitable beneficiary, the trust could continue to accumulate wealth for several generations without a taxable termination, even if the proposal limits the trust's ability to pay medical and educational expenses without incurring generation-skipping taxes. They argue that the focus should be on tightening the anti-abuse rules related to the use of non-skip beneficiaries for tax avoidance purposes. Moreover, Treasury already has the

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[264] In two rulings, Treasury upheld the exception for transfers from trusts made directly to an educational organization. See Private Letter Rulings 9109032, March 1, 1991, and 9823006, June 5, 1998.

[265] Sec. 2611(b) (*emphasis added*).

authority to disregard any interest used primarily to postpone or avoid generation-skipping transfer taxes.[266]

[266] Sec. 2652(c)(2).

PART XIII − REFORM TREATMENT OF FINANCIAL INDUSTRY INSTITUTIONS AND PRODUCTS

A. Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt

Present Law

A debt instrument has "market discount" if it is acquired other than at original issue for a price that is less than the principal amount of the debt instrument. Market discount generally arises when a debt instrument has declined in value subsequent to its issuance (for example, because of an increase in interest rates or a decline in the credit worthiness of the borrower).

In general, a holder of a debt instrument with market discount does not have to recognize any income with respect to the market discount until the debt instrument matures or is disposed. On the disposition of the debt instrument, the holder must treat any gain as ordinary income to the extent of the accrued market discount.[267] A partial payment on a bond causes accrued market discount to be recognized. A holder also may elect to include the market discount in income as it accrues.[268]

Original issue discount ("OID"), unlike market discount, is includible in income of the holder currently, using a constant interest rate.[269]

Description of Proposal

The proposal requires holders to include market discount in income in the same manner as OID. For purposes of determining and accruing market discount, the accrual is limited to the greater of (1) the original yield to maturity of the debt instrument plus five percentage points, or (2) the applicable Federal rate at the time the holder acquired the debt instrument plus five percentage points.

Effective date.−The proposal is effective for debt securities acquired after December 31, 2013.

Analysis

Present law provides a more favorable tax treatment for a holder of a debt instrument with market discount than a debt instrument with OID, notwithstanding that they are economically indistinguishable (i.e., both forms of discount represent substitutes for stated interest). The Administration proposal would eliminate this disparity.

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[267] Sec. 1276. In determining the amount of accrued market discount, the holder can elect between treating the discount as accruing (1) ratably or (2) on a constant yield basis.

[268] Sec. 1278(b).

[269] Sec. 1272(a).

The proposal would cap the yield by which the market discount would accrue to the greater of (1) the original yield to maturity of the debt instrument plus five percentage points, or (2) the applicable Federal rate at the time the holder acquired the debt instrument plus five percentage points. The cap is consistent with the policy reflected in the high yield discount obligation rules (that a portion of the holder's return from such an instrument, if realized, is more properly viewed as gain on an equity investment).

The proposal does not specify the extent to which any gain or loss on the disposition of a market discount bond is subject to capital or ordinary treatment. It may be argued that gain (determined after the basis of the debt has been increased by accruals) is similar to gain realized from an equity investment. On the other hand, if the holder includes market discount accruals in income and later sells the debt instrument at a loss, should any loss attributable to the accruals be treated as an ordinary loss because there was an over accrual of discount? OID and interest income included in income do not give rise to an ordinary loss under present law.

One issue with the Administration's proposal is the additional complexity it may cause. When the market discount rules were added to the Code as part of the Deficit Reduction Act of 1984, Congress recognized the economic equivalence of market discount and original issue discount, yet it enacted a different set of rules for market discount. Accordingly, "the Congress appreciated that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity."[270] This complexity can be reduced where the broker holding the bond reports market discount accruals to the holder.[271]

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[270] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,* (JCS-41-84) December 31, 1984, p. 93.

[271] See Treas. Reg. sec. 1.6045-1(n)(3) requiring brokers to report accrued market discount on the sale of a debt instrument.

B. Require that the Cost Basis of Portfolio Stock that is a Covered Security Must be Determined Using an Average Basis Method

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss).[272] The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.[273]

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.[274] The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some (but not all) of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[275] If a taxpayer makes an adequate identification ("specific identification") of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[276] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out method, to determine the basis of RIC shares sold under the average basis method.[277] In general, the average basis method for RIC shares provides that basis is determined by averaging the basis of all shares of identical stock in a taxpayer's account, regardless of holding period.[278]

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[272] See, *e.g., Helvering v. Bruun*, 309 U.S. 461, 469 (1940).

[273] Sec. 1001.

[274] Sec. 1016.

[275] Treas. Reg. sec. 1.1012-1(c)(1).

[276] Treas. Reg. sec. 1.1012-1(c).

[277] Treas. Reg. sec. 1.1012-1(e).

[278] Treas. Reg. sec. 1.1012-1(e)(7)(i). For this purpose shares of stock in a dividend reinvestment plan are not identical to shares of stock that are not in a dividend reinvestment plan. *Ibid.*

In the case of the sale, exchange, or other disposition of a specified security (defined below) to which the basis reporting requirement described below applies, the first-in-first-out rule, specific identification, and average basis method conventions are applied on an account by account basis.[279] To facilitate the determination of the cost of RIC stock under the average basis method, RIC stock acquired before January 1, 2012 generally is treated as a separate account from RIC stock acquired on or after that date unless the RIC (or a broker holding the stock as a nominee) elects otherwise with respect to one or more of its stockholders, in which case all the RIC stock with respect to which the election is made is treated as a single account and the basis reporting requirement described below applies to all of that stock.[280]

The basis of stock acquired after December 31, 2010 in connection with a dividend reinvestment plan ("DRP") is determined under the average basis method for as long as the stock is held as part of that plan.[281]

Basis reporting

A broker is required to report to the IRS a customer's adjusted basis in a covered security that the customer has sold and whether any gain or loss from the sale is long-term or short-term.[282]

A covered security is, in general, any specified security acquired after an applicable date specified in the basis reporting rules. A specified security is any share of stock of a corporation (including stock of a RIC); any note, bond, debenture, or other evidence of indebtedness; any commodity, or contract or derivative with respect to such commodity, if the Treasury Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Treasury Secretary determines that adjusted basis reporting is appropriate.

For purposes of satisfying the basis reporting requirements, a broker must determine a customer's adjusted basis in accordance with rules intended to ensure that the broker's reported adjusted basis numbers are the same numbers that customers must use in filing their tax returns.[283]

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[279] Sec. 1012(c)(1).

[280] Sec. 1012(c)(2).

[281] Sec. 1012(d)(1). Other special rules apply to DRP stock. See sec. 1012(d)(2) and (3).

[282] Sec. 6045(g) and Treas. Reg. sec. 1.6045-1(d).

[283] See sec. 6045(g)(2).

Description of Proposal

The proposal requires that a taxpayer use the average basis method to compute the basis of all identical shares of portfolio stock that the taxpayer has held for more than one year.[284]

The proposal's average basis requirement applies to identical shares of portfolio stock held by the taxpayer in a single account, in separate accounts with the same broker, and in separate accounts with different brokers.

The proposal does not apply to shares that a taxpayer holds in a retirement account or another nontaxable account.

The proposal grants the Treasury Secretary authority to prescribe regulations applying the average basis method requirement to stock other than portfolio stock.

Effective date.−The proposal applies to portfolio stock acquired on or after January 1, 2014.

Analysis

The proposal prohibits a taxpayer from minimizing gain or maximizing loss from the sale of some, but not all, of the taxpayer's holding of a particular stock by choosing the shares in which the taxpayer's basis is highest. A reason for this planning restriction is the view that the present law specific identification method of identifying shares sold is based on the fiction that, when a taxpayer holds multiple shares of stock of a company, those shares differ from one another. In reality, under this view, shares of stock of a company are fungible and should be treated as such.

The proposal recognizes that shares of stock are fungible only if they have the same legal and economic features such as entitlement to dividends and a share of growth. Accordingly, the proposal requires use of the average basis method only for "identical" shares of portfolio stock.[285] For example, the proposal does not mandate that a taxpayer use the average basis method across both preferred and common stock of the same company.

The proposal applies only to "portfolio" stock, a term that the proposal does not define. A portfolio holding commonly refer to ownership of less than a certain percentage, typically ten percent, of a company's stock. Assuming the proposal uses "portfolio" stock in this sense, it is unclear why the average basis requirement should not apply to larger, non-portfolio holdings. Larger holdings of a company's stock differ from portfolio ownership of that company's stock because the former but not the latter may confer on the owner some degree of control over the

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[284] For rules addressing the holding period of stock and other property, see sections 1222, 1223.

[285] The average basis method permitted under present law for RIC stock similarly is available for all shares of "identical" stock, with identical defined as stock with the same Committee on Uniform Security Identification Procedures ("CUSIP") number. Treas. Reg. sec. 1.1012-1(3)(4). A logical inference is that the proposal incorporates the same meaning of identical.

company. It is not self-evident why control or lack of control is relevant for whether taxpayers should be permitted to specifically identify shares of stock that they sell.

The proposal could, but does not, apply to property other than stock. For example, a taxpayer might be required to use the average basis method for determining the basis of bonds and other debt instruments held by the taxpayer. On the other hand, the computation of basis in a debt instrument may be complicated by adjustments under, for example, the original issue discount and market discount rules. As a practical matter, the concern over taxpayer gain minimizing or loss maximizing is less in the case of debt than stock because, in general, less of the return to debt ownership than to stock ownership is in the form of gain (as opposed to interest or dividends, amounts included in income annually). It might be harder to argue that other properties, such as individual parcels of real estate, to which the proposal could, in theory, apply are fungible with one another.

The proposal applies only to portfolio stock in which a taxpayer has a long-term holding period. Conceptually, the rationale that identical shares of stock are fungible is equally true irrespective of for how long a taxpayer has owned the shares. On the other hand, if taxpayers were required to group together long-term and short-term shares in making average basis computations, gains or losses that would be short-term (or long-term) under a separate share approach such as specific identification might shift to being long-term (or short-term).[286] For example, if a taxpayer owned an equal number of otherwise identical short-term shares and long-term shares, and the taxpayer had bought the short-term shares for $150 per share and the long-term shares for $30 per share, the taxpayer's average basis across all shares would be $90 per share, and on a sale of all the shares the taxpayer would shift $60 per share of gain from long-term to short-term relative to the short-term/long-term division that would have been made under a separate share approach. One way to avoid this shifting of gains and losses between short-term and long-term would be to require taxpayers to segregate shares into short-term and long-term categories and to make separate basis computations for the two categories.[287] This approach, though, would create greater complexity than under the proposal's single average basis computation. Under any approach to basis computation, however, rules will be necessary for determining which shares are deemed sold when a taxpayer sells less than all of a holding because only with these rules will it be possible to determine the extent to which gain or loss is treated as short-term or long-term.[288]

One question is the extent to which the proposal will complicate compliance with, and administration of, the recently effective basis reporting requirements. Those basis reporting requirements were predicated on present law basis computation rules. In particular, the basis

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[286] The present law average basis rules for RIC stock require a single averaging for all short-term and long-term shares and thereby result in this shifting. See Treas. Reg. sec. 1.1012-1(e)(7)(i).

[287] This was the approach of the double-category method applicable to RIC stock before the enactment of the basis reporting rules. See former Treas. Reg. sec. 1.1012-1(e)(3) (April 1, 2010).

[288] The present law average basis rules for RIC stock provide that shares sold are deemed to be the shares first acquired. Treas. Reg. sec. 1.1012-1(e)(7)(ii).

reporting rules provide that for stock other than RIC stock, a taxpayer's adjusted basis is determined using either the first-in first-out or specific identification method.[289] Brokers subject to the basis reporting requirements can be expected to have programmed their reporting systems to accommodate these two methods but not necessarily to accommodate the average basis method.

[289] Sec. 6045(g)(2)(B)(i)(I).

PART XIV − OTHER REVENUE CHANGES AND LOOPHOLES CLOSERS

A. Increase Tobacco Taxes and Index for Inflation

Present Law

Excise taxes are imposed on tobacco products and cigarette papers and tubes that are manufactured or imported into the United States. "Tobacco products" means cigars, cigarettes, smokeless tobacco (snuff and chewing tobacco), pipe tobacco, and roll-your-own tobacco. The tax liability comes into existence when the domestic tobacco products are manufactured and is determined and payable when the tobacco products or cigarette papers and tubes are removed from the bonded premises of the manufacturer. Tobacco products and cigarette papers and tubes may be exported from the United States without payment of tax.

A cigar is any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco (other than cigarettes). A cigarette is (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, and (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette. Snuff is any finely cut, ground, or powdered tobacco that is not intended to be smoked. Chewing tobacco is any leaf tobacco that is not intended to be smoked. Pipe tobacco is any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe. Roll-your-own tobacco is any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or cigars, or for use as wrappers thereof.

Manufacturers of processed tobacco are regulated under the internal revenue laws but no excise tax is imposed on processed tobacco. A manufacturer of processed tobacco is any person who processes any tobacco other than tobacco products. The processing of tobacco does not include the farming or growing of tobacco or the handling of tobacco solely for sale, shipment, or delivery to a manufacturer of tobacco products or processed tobacco.

Product	Tax Rates
Tobacco products (sec. 5701)	
"Small cigarettes" (weighing three pounds or less per thousand)	$50.33 per thousand[290]
"Large cigarettes" (weighing more than three pounds per thousand)	$105.69 per thousand[291]

[290] The tax rate equals $1.0066 per pack of 20 cigarettes.

[291] Large cigarettes more than 6.5 inches long are taxed as small cigarettes, counting each 2.75 inches in length (or fraction) as one cigarette.

Product	Tax Rates
"Small cigars" (weighing three pounds or less per thousand)	$50.33 per thousand
"Large cigars" (weighing more than three pounds per thousand)	52.75 percent of manufacturer's sales price, but not more than 40.26 cents per cigar[292]
Snuff	$1.51 per pound (proportionate rate on fractional parts of a pound)
Chewing tobacco	50.33 cents per pound (proportionate rate on fractional parts of a pound)
Pipe tobacco	$2.8311 per pound (proportionate rate on fractional parts of a pound)
"Roll-your-own" tobacco	$24.78 per pound (proportionate rate on fractional parts of a pound)
Cigarette papers[293]	3.15 cents for each 50 papers (or fractional part thereof)
Cigarette tubes	6.30 cents for each 50 tubes (or fractional part thereof)

Description of Proposal

The proposal increases the tax on cigarettes from $1.01 per pack to about $1.95 per pack and increases all other excise taxes on tobacco products and cigarette papers and tubes by roughly the same proportion beginning in 2014. Under the proposal, excise tax rates are increased each year for inflation.

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. Large cigars are exempt from the floor stocks tax. The floor stocks tax is payable on or before April 1, 2014.

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

[292] The price of large cigars on which tax is based is inclusive of any charge for putting the cigar into a condition ready for sale, and is exclusive of (1) Federal excise tax and (2) separately stated retail sales taxes imposed by any State or local government (regardless of whether the vendor or purchaser is liable for the tax).

[293] Cigarette papers measuring more than 6.5 inches in length are taxed at the rate prescribed, counting each 2.75 inches (or fraction thereof) as one cigarette paper. An identical rule applies to cigarette tubes more than 6.5 inches in length.

Effective date.−The proposal is effective for articles removed after December 31, 2013.

Analysis

An increase in the excise tax on tobacco products increases the cost of production. Some or all of the increased production cost may be passed on to consumers in the form of higher prices. As a result, consumers may consume less of these products. Some argue that current prices of tobacco products do not fully account for the private and external costs of consumption (e.g., the negative health effects on the user and others). They argue that tobacco products are over consumed because the price paid does not reflect all of the costs to society. If true, then an increase in tobacco taxes may increase efficiency by more closely reflecting the full social costs of tobacco use in the price of tobacco products. However, others suggest that the present excise taxes have already raised the price on tobacco products above the total private and external costs of tobacco consumption such that any additional tax increases the gap between price and costs, exacerbating the efficiency losses associated with the taxation of tobacco.

For many consumers, the demand for tobacco products is relatively unresponsive to changes in prices, and an increase in the tax may lead to a relatively modest decrease in the size of the demand for tobacco products. However, as a result of this relatively unresponsive demand, a significant share of the tax increase may be passed on to consumers in the form of higher prices. In other words, the incidence of the tax may be borne disproportionately by consumers relative to producers. If tobacco taxes are passed on to consumers in the form of higher prices, an increase in the tax on tobacco products is likely to have differential impacts on various groups of taxpayers as tobacco products are not consumed equally across the population. The use of tobacco products is higher among those with lower income levels, leading some to argue that much of the burden of increased tobacco taxes will be borne by those with the least ability to pay. Others suggest that since young consumers are more sensitive to the price of tobacco than older consumers, increasing tobacco taxes helps to curb youthful smoking, and therefore reduces the number of future smokers.

B. Restrict Deductions and Harmonize Rules for Contributions of Conservation Easements for Historic Preservation

Present Law

Charitable contributions, in general

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[294]

Contributions of partial interests in property

In general

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the taxpayer transfers a portion of his entire interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.[295] This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

Exceptions to the partial interest rule are provided for, among other interests: (1) an undivided portion of the taxpayer's entire interest in the property; (2) a remainder interest in a personal residence or farm; and (3) qualified conservation contributions.[296]

Qualified conservation contributions

Qualified conservation contributions are not subject to the partial interest rule.[297] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.[298] A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement).[299] Qualified organizations include

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[294] Secs. 170 (income tax), 2055 (estate tax), and 2522 (gift tax).

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

[296] See, *e.g.*, sec. 170(f)(3).

[297] Sec. 170(h)(1).

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

[299] Sec. 170(h)(2).

certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.[300]

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.[301]

In general, a contribution is not exclusively for conservation purposes and no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[302] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[303]

Preservation of a certified historic structure

A certified historic structure means (i) any building, structure, or land listed in the National Register, or (ii) any building located in a registered historic district (as defined in section 47(c)(3)(B)) and certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.[304] If restrictions to preserve a building within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[305]

In the Pension Protection Act of 2006,[306] the Congress enacted additional requirements for deducting easements on buildings located in a registered historic district.[307] The qualified real property interest that relates to the exterior of the building must preserve the entire exterior of the building, including the height, the sides, the rear, and the front of the building. In addition, such qualified real property interest must provide that no portion of the exterior of the building

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[300] Sec. 170(h)(3).

[301] Sec. 170(h)(4). Under a temporary provision that applies for contributions made in taxable years beginning before January 1, 2014, preferential percentage limits and carryforward rules apply for qualified conservation contributions. Sec. 170(b)(1)(E).

[302] Sec. 170(h)(5); Treas. Reg. sec. 1.170A-14(e)(2).

[303] Treas. Reg. sec. 1.170A-14(e)(2).

[304] Sec. 170(h)(4)(C).

[305] Treas. Reg. sec. 1.170A-14(d)(5)(i).

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

[307] Sec. 170(h)(4)(B).

may be changed in a manner inconsistent with the historical character of such exterior. Taxpayers must include with the return for the taxable year of the contribution (a) a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest); (b) photographs of the entire exterior of the building; and (c) descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. In addition, the donor and the donee must enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization with a specified preservation purpose (*e.g.*, historic preservation), and that the donee has the resources to manage and enforce the restrictions and a commitment to do so. Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of $10,000 must pay a $500 fee to the Internal Revenue Service or the deduction is not allowed.

The additional restrictions enacted in the Pension Protection Act for deducting easements on buildings in a registered historic district do not apply to easements on National Register properties.

Valuation of conservation restrictions

Valuation standards

The value of a charitable contribution of a conservation restriction granted in perpetuity is the fair market value of the restriction at the time of the contribution. Generally, this value is determined under the "before and after approach."[308] Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[309]

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution must be reduced by the amount of the increase in the value of the other property.[310] In addition, the donor must reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[311] If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.[312] In

[308] Where there is a substantial record of sales of comparable easements, the valuation must be based on the sales prices of such easements. Treas. Reg. sec. 1.170A-14(h)(3). Because such sales rarely occur, however, valuations of easements generally are determined using the before-and-after method.

[309] Treas. Reg. sec. 1.170A-14(h)(3).

[310] Treas. Reg. sec. 1.170A-14(h)(3)(i).

[311] *Ibid*.

[312] *Ibid*.

those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[313]

Appraisal requirements

A taxpayer is required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to his tax return.[314] For contributions of property for which a deduction of more than $500,000 is claimed, the taxpayer must attach the qualified appraisal to his tax return.[315] A qualified appraisal is an appraisal of property by a qualified appraiser conducted in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.[316] A qualified appraiser is an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience involving the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.[317]

Valuation-related penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[318] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least 150 percent of the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least 200 percent of the amount determined to be the correct value.[319] Any person who prepares an appraisal that is to be used to support a tax position that results in a substantial or gross valuation misstatement is subject to a civil penalty equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from the substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. The penalty does not apply if the appraiser establishes that it was more likely than not that the appraisal was correct. The Secretary may disqualify an appraiser from practicing before the IRS under certain circumstances.

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[313] Treas. Reg. sec. 1.170A-14(h)(3)(ii).

[314] Sec. 170(f)(11)(C).

[315] Sec. 170(f)(11)(D).

[316] Sec. 170(f)(11)(E)(i).

[317] Secs. 170(f)(11)(E)(ii) and (iii).

[318] Secs. 6662(b)(3) and 6662(h).

[319] Sec. 6662(e) and 6662(h).

Description of Proposal

The proposal disallows a deduction for any value of an historic preservation easement associated with forgone upward development above an historic building. The proposal also requires 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.

Effective date.−The proposal is effective for contributions made after the date of enactment.

Analysis

Valuing charitable contributions of property

The determination of fair market value creates a significant opportunity for error or abuse by taxpayers making charitable contributions of property. To the extent that taxpayers claim inflated valuations that are not corrected by the IRS, the Treasury loses revenue that should be collected under present law because charitable contribution deductions are greater than are warranted. Whether due to mistake, incompetence, misunderstanding of the law or facts, or efforts to evade taxes, valuation misstatements are common.

In addition, valuation is a difficult and resource intensive issue for the IRS to identify, audit, and litigate. The IRS must determine which values are suspect, prepare its own appraisal of the questioned property, and persuade a court that the IRS's value, and not the taxpayer's, is correct. Such hurdles may mean, as a practical matter, that attacking valuation misstatements in the charitable contribution context is not a high priority for the IRS because the probable revenue collected does not compare favorably with the resource cost (at least when compared to other tax compliance areas).

Unlike in an arm's length negotiation, in a charitable contribution situation, the interests of a donor and a donee organization are not adverse. A donee organization may have no knowledge of the amount a donor has claimed as the value of the easement and, even if known, has no incentive to question a donor's inflated value because there is no countervailing tax consequence to the donee if a donor inflates the value of contributed property, *i.e.*, the donee generally does not pay tax on the receipt of the contribution or a subsequent disposition of the contributed property. Some donees may even directly or indirectly support an inflated value in order to secure a desired gift. Such circumstances cause the valuation of property in the charitable contribution context to be a particularly difficult determination.

In recent years, the Congress has responded to these concerns by enacting several targeted provisions designed to increase certainty and limit valuation abuse in connection with charitable contributions of difficult-to-value property. In 2004, for example, the Congress enacted provisions regarding the deductibility of charitable contributions of used motor vehicles

and intellectual property.[320] In 2006, the Congress enacted additional provisions that addressed concerns about valuation of charitable contributions, including provisions: (1) imposing additional requirements for deducting contributions of clothing and household items; (2) restricting charitable deductions for contributions of taxidermy property; (3) limiting deductions for contributions of certain historic preservation easements; (4) imposing new standards for qualified appraisers and qualified appraisals; (5) lowering the thresholds for imposing accuracy related penalties in the case of gross valuation misstatements; and (6) imposing penalties on appraisers who participate in appraisals that result in a substantial or gross valuation misstatement.[321]

Policy concerns relating to conservation easement deductions

Charitable deductions of qualified conservation contributions present particularly serious policy and compliance issues. First, valuation is especially problematic because the measure of the fair market value of the easement (generally, the difference in fair market value before and after placing the restriction on the property) is highly speculative, considering that, in general, there is no market and thus no comparable sales data for such easements.

Furthermore, in many instances, present law does not require that the preservation or protection of conservation be pursuant to a clearly delineated governmental conservation policy, only requiring such a policy in cases of open space preservation if the preservation is not for the scenic enjoyment of the general public. As a result, taxpayers and donee organizations have considerable flexibility to determine the conservation purpose served by an easement or other restriction. This enables taxpayers to claim substantial charitable deductions for conservation easements that arguably do not serve a significant conservation purpose.

The ability of a donor of a qualified conservation contribution to use the retained property after the contribution of the partial interest also makes it difficult to determine whether a significant public benefit or conservation purpose is served by the contribution. For example, if a donor is able to continue to use real property as a residence after the contribution is made, the donor may benefit economically and in other ways from making the contribution, and the extent of the public benefit and conservation purpose may be diminished by such use.

In response to concerns about charitable deductions for conservation easements, in 2004 the IRS issued a notice informing taxpayers that it will examine conservation easement donations closely and, where appropriate, will deny tax benefits to, or impose sanctions on, donors,

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[320] American Jobs Creation Act of 2004, Pub. L. No. 108-357, secs. 882, 884. Under the vehicle provision, where a vehicle will not be used by the donee charity for its charitable purpose, the donor's deduction generally is limited to the gross proceeds from the sale of the vehicle. Sec. 170(f)(12). In the case of a contribution of intellectual property (such as a patent), the donor's initial deduction generally is the taxpayer's basis in the property (or, if less, the fair market value of the property); the donor may, however, take subsequent deductions as the donee charity receives income properly allocable to the intellectual property, if certain requirements are satisfied. Secs. 170(e)(1)(B)(iii) & 170(m).

[321] Pension Protection Act of 2006, Pub. L. No. 109-280, secs. 1213, 1214, 1216, and 1219.

recipient organizations, appraisers, and promoters of conservation easement transactions.[322] The notice states: "The purpose of this notice is to advise participants in these transactions that, in appropriate cases, the Service intends to disallow such deductions and may impose penalties and excise taxes. Furthermore, the Service may, in appropriate cases, challenge the tax-exempt status of a charitable organization that participates in these transactions. In addition, this notice advises promoters and appraisers that the Service intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers may be subject to penalties."[323]

The proposal is a direct response to such policy concerns. The first part of the proposal provides that a taxpayer may not take a deduction for any reduction in value resulting from forgone upward development of an historic building. As noted by the Treasury Department, "[s]ome taxpayers . . . 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."[324] On the other hand, some may argue that the provision is overbroad and could eliminate deductions where donors have parted with real and ascertainable value, such as where the restrictions included in the easement clearly exceed those that exist under local law.

The second part of the proposal extends to National Register properties the additional requirements added by the Pension Protection Act for easements on buildings in registered historic districts. This portion of the proposal similarly is a direct response to the above-discussed policy concerns. In addition, although certain of the requirements for obtaining National Register or registered historic district status may differ, the proposal arguably lends consistency to the tax laws regarding deductions for contributions of easements on historic properties.

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[322] Notice 2004-41, 2004-1 C.B. 31, June 30, 2004.

[323] *Ibid*.

[324] Department of the Treasury, *"General Explanation of the Administration's Fiscal Year 2014 Revenue Proposals,"* April 2013, p.162.

C. Require Nonspouse Beneficiaries of Deceased IRA Owners and Retirement Plan Participants to Take Inherited Distributions Over No More Than Five Years

Present Law

In general

Tax-favored treatment applies to employer-sponsored retirement plans that meet certain requirements and to individual retirement arrangements ("IRAs").[325] Minimum distribution rules apply to tax-favored employer-sponsored retirement plans and IRAs.[326] In general, under these rules, during an employee's (or IRA owner's)[327] lifetime, distribution of minimum benefits must begin no later than the required beginning date and a minimum amount must be distributed each year.[328] Minimum distribution rules also apply to benefits payable with respect to an employee who has died. Regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA. In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the annuity stream of payments must satisfy.[329]

Failure to comply with the minimum distribution requirement for a year may result in an excise tax (imposed on the individual who was required to take the distribution) of 50 percent of the portion of the required distribution for the year that was not distributed.[330] In the case of an employer-sponsored plan, failure to comply with the minimum distribution requirement may result in loss of tax-favored status.

Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 70½. For employer-sponsored plans, for an employee other

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[325] Tax-favored employer-sponsored retirement plans include qualified retirement plans and annuities under sections 401(a) and 403(a), tax-deferred annuity plans under section 403(b), and eligible deferred compensation plans of governmental employers under section 457(b).

[326] Secs. 401(a)(9), 403(b)(1), 408(a)(6), 408(b), and 457(d)(2). The minimum distribution rules apply also to eligible deferred compensation plans of nongovernmental tax-exempt employers.

[327] Except where otherwise indicated, references herein to "employee" include IRA owners.

[328] Under section 408A(c)(5), these requirements do not apply to a Roth IRA. For a discussion of traditional and Roth IRAs, see Joint Committee on Taxation, *Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups* (JCS-3-13), May 6, 2013, Part II.I.4.

[329] Under section 823 of the Pension Protection Act of 2006, Pub. Law No. 109-280, and Treas. Reg. sec. 1.401(a)(9)-1, A-2(d), a tax-favored employer-sponsored retirement plan that is a governmental plan is treated as having complied with the minimum distribution rules if the plan complies with a reasonable and good faith interpretation of the statutory rules.

[330] Sec. 4974. The excise tax may be waived in certain cases.

than a five-percent owner in the year the employee attains age 70½, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee under an employer-sponsored plan who is a five percent owner in the year the employee attains age 70½, the required beginning date is the same as for IRAs, even if the employee continues to work past age 70½.

Lifetime rules for individual accounts

While an employee is alive, distributions of the employee's interest are required to be made (in accordance with the regulations) over the life or life expectancy of the employee, or over the joint lives or joint life expectancy of the employee and a designated beneficiary.[331] For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee is alive, is the factor from the uniform lifetime table included in the Treasury regulations.[332] This table is based on the joint life and last survivor expectancy of the employee and a hypothetical beneficiary 10 years younger.

Distributions after death

Payments over a distribution period

The rules for distributions after death vary depending on (1) whether an employee dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit. Under the regulations, a designated beneficiary is an individual designated as a beneficiary under the plan.[333] Similar to the lifetime rules, for defined contribution plans and IRAs, the required minimum distribution for each year after the death of the employee is generally determined by dividing the account balance as of the end of the prior year by a distribution period.[334]

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[331] Sec. 401(a)(9)(A).

[332] Treas. Reg. sec. 1.401(a)(9)-5. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

[333] Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan. There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, if an individual is named as beneficiary through the employee's will or the estate is named as beneficiary, there is no designated beneficiary for purposes of the minimum distribution requirements.

[334] If the employee's surviving spouse is the beneficiary, the surviving spouse generally is permitted to roll his or her interest over on a nontaxable basis to his or her own IRA or a tax-favored employer-sponsored plan in which he or she participates. If the surviving spouse is the sole beneficiary of an IRA, this rollover can be accomplished by simply renaming the IRA as an IRA owned by the surviving spouse. In either case, with respect to the rollover account, the surviving spouse is treated as the employee (rather than as a designated beneficiary) for purposes of the minimum distribution rules.

If an employee dies on or after the required beginning date, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death.[335] Under the regulations, for individual accounts, if there is no designated beneficiary, the distribution period is equal to the remaining years of the employee's life expectancy, as of the year of death.[336] If there is a designated beneficiary, the distribution period (if longer than the employee's remaining life expectancy) is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of the death.[337]

If an employee dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, distributions generally are required to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and are permitted to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary.[338] Under the regulations, for individual accounts, the distribution period is measured by the designated beneficiary's life expectancy, calculated in the same manner as when the employee dies on or after the required beginning date.[339]

In all cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period.[340]

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[335] Sec. 401(a)(9)(B)(i).

[336] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a)(2).

[337] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a)(1).

[338] In the case of a designated beneficiary who is the surviving spouse, special rules apply (in addition to the rule allowing a surviving spouse to roll an inherited interest over to the spouse's own IRA or employer's plan). In that case, distributions are not required to commence until the year in which the employee would have attained age 70½. If the surviving spouse dies before the employee would have attained age 70½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee.

[339] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[340] If the distribution period is based on the surviving spouse's life expectancy (whether the employee's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

Five-year rule

If an employee dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee must generally be distributed by the end of the fifth calendar year following the individual's death.[341]

Defined benefit plans and annuity distributions

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity contract purchased from an insurance company (including an annuity contract held in an employee's account under a defined contribution plan) paid over an individual's life or life expectancy.[342] Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five percent per year), certain accelerations of payments, and increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a qualified domestic relations order.[343] If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee, the survivor annuitant is limited to a percentage of the life annuity benefit for the employee. The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.[344]

Anti-cutback rules

Tax-favored employer-sponsored retirement plans often offer employees multiple options as to the form in which to receive benefits (for example, as a lump sum, in installments, or as an annuity), referred to as optional forms of benefit. For married participants, certain qualified retirement plans are required to offer a qualified joint and survivor annuity ("QJSA"), which is generally a life annuity for the participant with an annuity of at least 50 percent of the participant's annuity amount payable to the surviving spouse after the participant's death. In addition, a plan that offers annuity benefits may allow an employee to designate a nonspouse beneficiary (only with spousal consent in the case of a married participant).

The requirements for qualified retirement plans include various protections for benefits that employees have already earned, including the "anti-cutback" rules. Under these rules, amendments that eliminate optional forms of benefit with respect to previously earned benefits

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[341] In some cases, this rule may apply to a designated beneficiary. See Treas. Reg. sec. 1.401(a)(9)-4, A-4.

[342] Treas. Reg. sec. 1.401(a)(9)-6.

[343] Treas. Reg. sec. 1.401(a)(9)-6, A-14.

[344] Treas. Reg. sec. 1.401(a)(9)-6, A-2(c).

are prohibited unless permitted under regulations.[345] Exceptions to the "anti-cutback" rules apply. For example, optional forms of benefit under a defined contribution plan can generally be eliminated as long as the plan offers lump sums payable at the same times, and the IRS may allow the elimination of an optional form of benefit (or other protected benefit) to the extent required to comply with a statutory change.[346]

Description of Proposal

Under the proposal, after an employee's death, a nonspouse beneficiary, other than an eligible beneficiary, is required to take distributions over no more than five years.[347] For this purpose, an eligible beneficiary is any beneficiary who, as of the date of the employee's death, is (1) disabled, (2) a chronically ill individual, (3) an individual who is not more than 10 years younger than the employee, or (4) a child who has not reached the age of majority.

In the case of an eligible beneficiary, distributions are generally allowed over the life or life expectancy of the beneficiary, beginning in the year following the year of the death of the employee. However, in the case of an eligible beneficiary who is a minor child, the benefit must be fully distributed no later than five years after the child reaches the age of majority.

On the death of any beneficiary, including a surviving spouse or an eligible beneficiary, any remaining balance would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the participant's death.

Effective date.−The proposal is generally effective for distributions with respect to employees 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 applies also with respect to employees who die before January 1, 2014, but only if the beneficiary dies after December 31, 2013. The proposal does not apply in the case of an employee whose benefits are determined under a binding annuity contract in effect on the date of enactment.

Analysis

The tax subsidy for retirement savings is intended to provide an incentive for individuals, particularly middle- and lower-income individuals, to save for retirement. Various additional incentives, such as higher contribution limits than those applicable to IRAs, apply with respect to

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[345] Sec. 411(d)(6). The "anti-cutback" rules generally prohibit amendments that reduce an employee's accrued benefit (whether or not vested) or eliminate optional forms of benefit or eliminate or reduce early retirement benefits or retirement-type subsidies with respect to the employee's accrued benefit. Most governmental plans and church plans are excepted from these rules.

[346] Treas. Reg. sec. 1.411(d)-4(e) and -4(b)(2)(i).

[347] The proposal does not change the rules for minimum distributions to a surviving spouse during the lifetime of the surviving spouse or the ability of a surviving spouse to roll the inherited benefit over to his or her own retirement plan or IRA.

employer-sponsored plans in order to encourage employers to sponsor plans, thereby increasing the potential for middle- and lower-income employees to save for retirement. At the same time, some aspects of the tax rules are intended to limit the amount that can be saved on a tax-favored basis to an amount reasonably needed for retirement and to maximize the chance that tax-favored savings will in fact be used for retirement. With respect to the latter goal, restrictions on distributions from employer-sponsored retirement plans and additional taxes applicable if distributions are taken before retirement age, death or disability help to preserve savings until retirement.[348] The minimum distribution rules attempt to assure that tax incentives for retirement savings are not instead used as a means of accumulating wealth to pass on after death.

Some view the present-law minimum distribution rules for nonspouse beneficiaries as allowing savings to stay in tax-favored form for longer than is appropriate. In many cases, a designated beneficiary is not dependent on the employee for support, yet is permitted to take distributions over his or her lifetime or life expectancy. Depending on the age of a beneficiary, the required minimum distribution for the beneficiary may be less than the earnings on the account for the year and thus may allow not only continued tax deferral of the amount of the employee's account balance at death but also additional tax-deferred growth of the account.[349] A desire to maximize tax-deferred treatment in some cases leads to the designation of as young a beneficiary as possible.

The proposal addresses these concerns by requiring distributions over five years after the employee's death, except in the case of certain "eligible" nonspouse beneficiaries. Eligible beneficiaries include individuals who are likely to have been supported by the employee (a minor child), or to have a particular income need over the individual's lifetime (a disabled or chronically ill individual), or whose life expectancy is not expected to result in significantly longer tax deferral than the employee's (an individual not more than 10 years younger than the employee). Nonetheless, some may view the definition of eligible beneficiary as too narrow to accommodate the various relationships that may provide a legitimate reason for an employee to want to provide a particular beneficiary with income over the beneficiary's lifetime at the higher level possible with tax-deferred growth. For example, an employee may wish to provide lifetime retirement income for a sibling who has limited financial means and is more than 10 years younger. Others may note that the proposal does not prevent the employee from providing lifetime retirement income for the sibling, but merely limits doing so on a tax-deferred basis.

Under the present-law minimum distribution rules, if the original spouse or nonspouse beneficiary of an employee dies, distributions are required only over the original beneficiary's

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[348] Restrictions on distributions before termination of employment ("in-service" distributions) and before a certain age apply to defined benefit plans, certain defined contribution plans, section 403(b) plans and section 457(b) plans. In addition, under section 72(t), unless an exception applies, a ten-percent additional tax applies to the portion of a distribution from a tax-favored retirement plan before age 59½ that is includable in income.

[349] Under the single life table in Treas. Reg. sec. 1.401(a)(9)-9, A-1, an adult beneficiary age 60 or younger has a life expectancy of more than 25 years, resulting in an initial required distribution of less than four percent of the account balance. Under the table, the life expectancy of an individual age 33 or younger is more than 50 years, resulting in an initial required minimum distribution of less than two percent of the account balance.

remaining life expectancy as of the time of death. This provides the opportunity for further tax deferral beyond the period of the beneficiary's life. The proposal addresses this by requiring distributions over five years after the death of the original beneficiary, including an eligible beneficiary or a surviving spouse.

The proposal is silent as to whether the five-year rule applies only in the case of a surviving spouse who dies after distributions to the surviving spouse were required to commence, that is, the year in which the employee would have attained age 70½. If, under the proposal, the five-year rule is intended to apply also in the case of a surviving spouse who dies before distributions to the surviving spouse were required to commence, the proposal repeals the present-law rule under which, if a surviving spouse dies before the employee would have attained age 70½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee.[350] This aspect of the proposal should be clarified.

The proposal is effective for distributions with respect to employees who die after December 31, 2013. In the case of an employee who dies before January 1, 2014, if the employee's beneficiary dies after December 31, 2013, the five-year required distribution period after the death of the beneficiary under the proposal will apply.

In some cases this effective date may be viewed as disruptive for older employees (and retirees) and their beneficiaries, who are likely to have made retirement-related financial decisions based on present law. However, providing exceptions for such situations is likely to be complicated and burdensome. In addition, this concern is addressed in part by an exception in the case of an employee whose benefits are determined under a binding annuity contract. This exception reflects a recognition that annuity benefits generally cannot be changed once the terms of the annuity have been set. There are, however, some ambiguities as to the scope of this exception, for example, whether it applies to annuity distributions from a defined benefit plan and how it applies to an employee's beneficiary.

Some transition period may be needed for employers and plan administrators (and, possibly, IRA providers) to assess the changes needed to plan terms and operations to implement the proposal and to make the necessary changes. In addition, a delayed effective date may be appropriate for governmental plans, which sometimes require legislative action to be amended, and for plans maintained pursuant to collective bargaining agreements to accommodate the collective bargaining process.

With respect to qualified retirement plans, some optional forms of benefit currently offered, such as a joint and survivor annuity with the survivor annuity payable to a beneficiary other than a spouse or eligible beneficiary, may be impermissible under the minimum distribution rules as modified by the proposal. In that case, an exception to the anti-cutback rules may be required to allow such optional forms to be eliminated. Rather than relying on the IRS to exercise its authority to provide an exception, an exception could be provided legislatively.

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[350] As previously noted, however, the proposal does not change the present-law rules under which, if the original beneficiary is a surviving spouse, the spouse may roll the inherited benefit to his or her own retirement plan or IRA. In that case, at his or her death, the rules for surviving spouse and eligible beneficiaries may apply.

Some aspects of the proposal require additional development, such as the definitions of "disabled" and "chronically ill." However, existing Code definitions may be used for this purpose.[351]

[351] See, for example, sections 72(m)(7), defining "disabled," and 7702B(c)(2), defining "chronically ill individual."

D. Limit Accruals Under Tax-Favored Retirement Plans

Present Law

In general

There are several types of tax-favored employer-sponsored retirement plans: qualified retirement plans,[352] tax-deferred annuity plans ("section 403(b)" plans),[353] and eligible deferred compensation plans of State or local governmental employers ("governmental section 457(b)" plans),[354] simplified employee pensions ("SEPs"),[355] and simple retirement plans. These employer-sponsored retirement plans have certain characteristics of tax-favored treatment in common. Even if the arrangement is funded and benefits are vested, most contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed (or, in the case of Roth arrangements,[356] contributions are after-tax but qualified distributions are not includable in gross income). Additionally, many distributions can be rolled over to another plan for further deferral of income inclusion. The rollover may be achieved by a direct trustee-to-trustee transfer or a distribution and contribution (within 60 days of the distribution) to another tax-favored retirement plan. Contributions and earnings under qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are held in a tax-exempt trust or custodial account or are funded using annuity contracts. SEPs and certain simple retirement plans ("SIMPLE IRAs")[357] are funded using a traditional individual retirement arrangement ("IRA") for each participating employee. IRAs receive tax-favored treatment similar to employer-sponsored plans, including tax-free rollover.

Tax-favored retirement plans are of two general types: (1) defined benefit plans, under which benefits are determined under a plan formula, and (2) defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings, and losses.

The defined benefit plan formula is generally either a traditional formula under which benefits are expressed as an annuity commencing at a retirement age, usually as a percentage of pay for each year of service, or a hybrid formula under which benefits are expressed as a hypothetical account balance, but with a right to an equivalent annuity. The accrued benefit of a participant as of the end of any plan year during employment is the annuity benefit that would be payable at normal retirement age under the plan if the employee terminated employment on the

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[352] Secs. 401(a) and 403(a).

[353] Sec. 403(b).

[354] Sec. 457.

[355] Sec. 408(k).

[356] Sec. 402A and 408A.

[357] Sec. 408(p).

last day of the plan year with benefits that were 100 percent vested. Defined benefit plans generally provide for payment in a "normal" form (the form in which the benefits under the plan are expressed under the plan's benefit formula or an actuarially equivalent annuity commencing at the plan's normal retirement age) but also may provide for payment under other optional forms of benefit. The optional forms of benefits must be at least the actuarial equivalent of the normal form of the accrued benefit, but, subject to certain limits, may have a greater actuarial value than the normal form of benefit. For example, the normal form of benefit under a plan might be expressed as a life annuity commencing to the participant at the plan's normal retirement age but an optional form may provide a life annuity commencing at an earlier age or provide a joint and survivor annuity, in either case without a full actuarial reduction in the participant's annuity payments. To the extent an optional form has a greater actuarial value than the normal form of benefit, the difference is generally called a benefit subsidy.

Defined contribution plans generally may provide for nonelective contributions and matching contributions by employers and elective deferrals (either pretax or Roth contributions) or after-tax contributions by employees. Elective deferrals are contributions made pursuant to an election by an employee between cash compensation and a contribution to the plan.

Tax-favored retirement plans are subject to dollar limits on the benefits and contributions provided under the plan.[358] The dollar limits are indexed to reflect cost-of-living increases.[359] The dollar limits generally limit the benefits that may accrue, or contributions that may be made, under a plan even if the benefits under the plan are not yet vested (i.e., are subject to forfeiture).

Qualified retirement plans

Dollar limits on benefits under defined benefit plans

In the case of a qualified defined benefit plan, a dollar limit applies on the amount of benefits payable with respect to a participant. The dollar limit is expressed in terms of a benefit commencing at age 62 in the form of a straight life annuity for the life of the participant.[360] The dollar limit on the annual payments under the annuity is $205,000 a year (for 2013 but increasing

[358] The limit on contributions or benefits is generally the lesser of a dollar limit or a percentage of the employee's compensation.

[359] For each limit, there is a rounding rule under which any increase that is not a multiple of a specified dollar amount (such as $500) is rounded down to the next lowest multiple for that dollar amount.

[360] Under Treas. Reg. sec. 1.415(b)-1(b)(1), a straight life annuity is an annuity payable in equal installments for the life of the participant that terminates upon the participant's death.

to $210,000 a year for 2014).[361] The dollar limit applies to the aggregate of all benefits accrued by an employee under all defined benefit plans maintained by the same employer.[362]

If payments under the plan with respect to a participant are made in a form other than a straight life annuity commencing at age 62, the benefits payable under such other form (including any benefit subsidies) generally cannot exceed the defined benefit plan dollar limit when actuarially converted to a straight life annuity commencing at age 62. Thus, the dollar limit is effectively reduced for distributions commencing before age 62 or for a form of benefit more valuable than a straight life annuity. However, if benefits are paid in the form of a qualified joint and survivor annuity (as discussed below) for the life of the participant with the participant's spouse as the survivor, no actuarial reduction is required in applying the dollar limit to reflect the value of the survivor benefit, even if the surviving spouse annuity is 100 percent of the participant's benefit. Thus, an annual benefit of $205,000 (for 2013 but increasing to $210,000 for 2014) commencing at age 62 for the life of the participant and continuing for the life of the participant's surviving spouse satisfies the limit.

For purposes of actuarially adjusting a benefit in a form other than an annuity, such as a lump-sum benefit, the interest rate used generally must be not less than the greatest of: (1) 5.5 percent; (2) the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the rate (or rates), and mortality assumptions, applicable in determining minimum lump sums were used (as discussed below); or (3) the interest rate specified in the plan.

Minimum lump sum distributions from defined benefit plans

In the case of a distribution from a defined benefit plan of an individual's entire accrued benefit in the form of a single sum (generally referred to as a lump sum), the amount of the single sum must not be less than the actuarial present value of the accrued benefit in the normal form calculated using specified interest rates and a specified mortality table.[363] The specified interest rates (referred to as corporate bond "segment" rates) are determined by the Treasury Department based on a corporate bond yield curve that reflects the monthly yields on investment grade corporate bonds with varying maturities. The segment rates depend on the timing of the expected payments under a participant's annuity benefit, with the first segment rate applicable to payments that would be made in the next five years, the second segment rate applicable to applicable to payments that would be made in the following 15 years, and the third segment rate applicable to payments that would be made thereafter. Thus, the interest rate that applies depends upon how many years in the future a participant's annuity payment will be made. Typically, a higher interest applies for payments to be made further out in the future.

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[361] Sec. 415(b)(1)(A). The limit actually is expressed as an annuity commencing at age 65, but there is no actuarial adjustment required for commencement between age 62 and 65.

[362] In applying the limits under both defined benefit plans and defined contributions plans, and the qualification requirement generally to a plan, the members of a control group as determined under section 414(b), (c), (m) , and (o) are treated as a single employer.

[363] These actuarial assumptions are required to determine minimum actuarial equivalent benefits under all forms of benefit other than life annuities.

Subject to certain conditions, a special rule applies in the case of a hybrid plan under which each employee's accrued benefit is calculated as the balance of a hypothetical account. Under the special rule, the plan does not violate the requirements for determining single sums merely because the plan provides that the actuarial present value of the employee's accrued benefit for purposes of determining any single sum distribution of the employee's entire accrued benefit is equal to the employee's hypothetical account balance.[364]

Dollar limits on contributions under defined contribution plans

In general

In the case of a qualified defined contribution plan, a dollar limit applies on the amount of contributions that can be made for each employee for a year under all defined contribution plans of the same employer. The dollar limit is $51,000 (for 2013 but increasing to $52,000 for 2014), and generally applies allocations to a participant's account under the terms of the plan as of any date during the year.[365]

In some cases, contributions are actually made to a plan and allocated to a participant's account after the end of the year, but are considered to be made as of the last day of the year. For example, employer contributions for a year may generally be made up to 8½ months after end of the year. In the case of a discretionary profit-sharing plan, an employer can wait until the date by which contributions must be made to decide how much to contribute to the plan (in total) as long as there is a specific formula under the plan for allocating the amount among participants.[366]

Elective deferrals

Certain qualified defined contribution plans ("section 401(k)" plans) include a feature under which an employee may elect to have contributions (elective deferrals) made to the plan, rather than receive the same amount in cash, subject to a dollar maximum. The dollar limit on maximum elective deferrals allowed for any employee is $17,500 (for 2013 and 2014) and is applied to the amount of deferrals for the employee's taxable year (which is generally the calendar year).[367] Additional elective deferrals ("catch-up contributions") are allowed for employees aged 50 or older, up to a dollar limit of $5,500 (for 2013 and 2014). Elective deferrals up to these limits are either not includable in gross income (but then subsequent distributions attributable to the contributions are includable in gross income) or are designated Roth contributions (in which case the contributions are includable in gross income but then subsequent qualified distributions attributable to the Roth contributions are excludible from gross income).

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[364] Sec. 411(a)(13). The same rule applies if the accrued benefit is calculated as an accumulated percentage of the employee's final average compensation.

[365] Sec. 415(c)(1)(A). Employee contributions to a defined benefit plan are also taken into account for purposes of this limit.

[366] Treas. Reg. sec. 1.401-1(b)(1)(ii).

[367] Sec. 402(g).

Elective deferrals, other than catch-up contributions, are included in applying the general dollar limit on contributions ($51,000 for 2013 increasing to $52,000 for 2014). Elective deferrals are contributions for the year in which deferred, even if actually contributed to the plan after the end of the year.[368]

Minimum vesting schedules

Under the minimum vesting rules, a participant's right to the employer-provided benefits he or she has earned under a plan (including the participant's account balance under a defined contribution plan) generally must become nonforfeitable (that is, vested) after a specified period of service and at attainment of normal retirement age under the plan.[369]

Under a qualified defined contribution plan, a participant must vest in the account balance attributable to employer contributions no slower than under a three-year cliff vesting schedule (that is, full vesting after three years of service) or a two-to-six-year graduated vesting schedule (that is, a specified percentage is vested after each year of service in this period).

Under a defined benefit plan with only a traditional benefit formula, a participant must vest in his or her employer-provided accrued benefit no slower than under a five-year cliff vesting schedule or a three-to-seven-year graduated vesting schedule. Under a defined benefit plan with a hybrid benefit formula, a participant must vest in his or her employer-provided accrued benefit no slower than under a three-year cliff vesting schedule. However, a defined benefit plan may condition eligibility for optional forms of benefit, including subsidized benefits, on service in addition to the service required under the plan's vesting schedule. For example, a plan with a normal retirement age of 62 might provide an unreduced (that is, subsidized) early retirement benefit at age 55 for an employee who works for the employer until age 55 and has at least 30 years of service at that age.

Nondiscrimination requirements

A qualified retirement plan must also satisfy certain nondiscrimination requirements, under which the coverage and contributions or benefits provided to employees under the plan must not discriminate in favor of highly compensated employees.[370] For purposes of these nondiscrimination requirements, an employee generally is treated as highly compensated if the

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[368] Under 29 C.F.R. sec 2510.3-102(d)(1)(i), in the case of a plan subject to the Employee Retirement Security Act of 1974 (ERISA), employee contributions (including elective deferrals) must be contributed to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. Thus, such amounts must be contributed to a plan within a short period after being deducted from an employee's pay.

[369] Sec. 411. The portion of a participant's account balance under a defined contribution plan, or benefit under a defined benefit plan, that is attributable to the participant's own contribution (including elective deferrals) must at all times be fully vested.

[370] Secs. 401(a)(3) and (4). Under section 403(b)(1)(D) and (b)(12), a section 403(b) plan of a nongovernmental tax-exempt employer (other than a church) is generally also subject to these requirements.

employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $115,000 (for 2013 and 2014).[371] Thus, generally, if a plan covers some highly compensated employees for a year and provides them with benefits or contributions, the plan must cover a nondiscriminatory group (as determined under the Code) and provide nondiscriminatory benefits or contributions for the group of employees covered. Accordingly, an employer that provides benefits or contributions under its plans to any highly compensated employee must provide benefits and contributions to some employees who are not highly compensated at a nondiscriminatory level. However, a qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements.[372] Further, qualified retirement plans are generally not subject to the nondiscrimination requirements with respect to benefits provided to collectively-bargained employees.

Qualified joint and survivor annuity requirements

Pension plans (defined benefit plans and money purchase pension plans[373]) must provide that the normal form of benefit under the plan is a qualified joint and survivor annuity.[374] For an unmarried participant, a qualified joint and survivor annuity is a life annuity, and, for a married participant, a qualified joint and survivor annuity generally is a life annuity for the employee with at least a 50-percent survivor annuity for the participant's spouse. The accrued benefit must be paid in the form of a qualified joint and survivor annuity unless the participant elects another form of distribution and, in the case of a married participant, the participant's spouse provides notarized consent to the alternative form of distribution.

In the case of a defined benefit plan, the other forms of benefit offered to a married participant under the plan may not be actuarially more valuable than the qualified joint and survivor annuity immediately payable at the time of the distribution. Finally, the qualified joint and survivor annuity requirement only applies if the actuarial present value of the participant's accrued benefit at the time of the distribution (calculated using the same actuarial assumptions that apply in determining minimum lump sums) is more than $5,000.

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[371] Sec. 414(q). Further, at the election of the employer, employees who are highly compensated based on the amount of the employee's compensation may be limited to any employee who had compensation for the preceding year in excess of $115,000 (for 2013 and 2014) and was in the top 20 percent of employees by compensation for such year.

[372] Governmental plans are also exempt from certain other qualification requirements, including requirements that have parallels under ERISA, such as the vesting requirements and the qualified joint and survivor requirements.

[373] A money purchase pension plan is a type of defined contribution plan that meets the definition of pension plan under Treas. Reg. sec. 1.401-1(b).

[374] In the case of a profit-sharing plan or stock bonus plan, including a section 401(k) plan, the plan is generally not required to satisfy the qualified joint and survivor requirement unless the participant elects an annuity form of distribution. However, in order for this exception to apply, the spouse must be the beneficiary of the employee's account balance after the employee's death unless the spouse consents in writing to a different beneficiary.

Section 403(b) plans

Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations,[375] and (2) educational institutions of State or local governments (i.e., public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of their employees, and the plan may provide for employees to make pretax elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the general dollar limit on contributions ($51,000 for 2013 but increasing to $52,000 for 2014) and the special dollar limits for elective deferrals ($17,500 for 2013 and 2014) and catch-up contributions ($5,500 for 2013 and 2014) under a section 401(k) plan. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans.[376]

Governmental section 457(b) plans

Deferrals under a governmental section 457(b) plan are generally subject to the same dollar limits as elective deferrals ($17,500 for 2013 and 2014) and catch-up contributions ($5,500 for 2013 and 2014) under a section 401(k) plan or a section 403(b) plan. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan.

Employer-sponsored retirement plans using IRAs

SIMPLE IRA plan

An employer that employs no more than 100 employees who earned $5,000 or more during the prior calendar year can establish a simple retirement plan, under which an IRA is established for each employee (that is, a SIMPLE IRA). A simple retirement plan allows employees to make elective deferrals, but is subject to a special dollar limit, $12,000 (for 2013 and 2014), and a special catch-up dollar limit for an individual age 50 or over, $2,500 (for 2013 and 2014).

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

[376] Any elective deferrals under SIMPLE IRAs and SARSEPs are also taken into account for purposes of this single limit.

Simplified employee pension plan

A simplified employee pension ("SEP") is a type of employer-sponsored retirement plan under which an employer may make contributions to a SEP IRA for each eligible employee up to the lesser of 25 percent of the employee's compensation or the dollar limit applicable to contributions to a qualified defined contribution plan ($51,000 for 2013 but increasing to $52,000 for 2014).

Certain SEP plans established before 1997 may include a salary reduction feature ("SARSEP") under which employees can make elective deferrals. Elective deferrals under a SARSEP are subject to the same dollar limit that applies to elective deferrals under a section 401(k) plan ($17,500, plus catch-up contributions up to $5,500 for a participant age 50 or over, for 2013 and 2014).

Correction of excess deferrals

If an individual's total elective deferrals for a taxable year under section 401(k) plans and section 403(b) plans exceed the applicable dollar limit, the excess is includible in income in the year for which it is contributed. If the plan distributes the excess (plus allocable income) by April 15 following the taxable year, the excess amount is not includable in the individual's gross income for the year distributed.[377] If the excess is not distributed by April 15, the excess is not only includable in gross income in the year contributed but the individual receives no basis in the account for the amount included in gross income. Thus, that amount will be taxed again when distributed. In the case of an excess in the form of designated Roth contributions, any distribution attributable to the excess cannot be a qualified distribution.

Dollar limits on individual savings contributions to IRAs

There are two types of IRAs: traditional and Roth. Individuals may make deductible and nondeductible contributions to traditional IRAs; nondeductible contributions result in basis. Distributions from traditional IRAs are includable in gross income except to the extent that a portion of a distribution is a recovery of basis. Contributions to Roth IRAs are nondeductible, but distributions from the Roth IRA may be received tax-free if the applicable conditions are satisfied. The dollar limit for an individual's contributions to all IRAs (traditional and Roth IRAs) is $5,500 (for 2013 and 2014). For individuals over age 50, the dollar limit is increased by a catch-up amount of $1,000 (which is not indexed). Individuals are allowed to make contributions for a taxable year through the due date for filing the individual's income tax return (without extensions) for such taxable year, generally April 15 of the following year.

Reporting to IRS

[377] In the case of one or more plans maintained by an employer, the plan or plans generally must enforce the limit. However, an employee who makes elective deferrals during the year to plans of different employers may exceed the limit. Generally, in that case, the employee informs a plan that an excess has occurred and requests that the plan distribute the excess amount.

IRA trustees report the total value of the account balance as of the end of the year, and the amount contributed to the IRA for the year (including rollover contributions), to the individual and to the IRS. Elective deferrals are required to be reported on an employee's Form W-2. Otherwise, the amount of contributions under employer-sponsored retirement plans with respect to individual employees generally are not reported to the IRS.

Description of Proposal

If an individual has accumulated amounts under tax-favored retirement plans sufficient to provide a maximum annuity commencing at age 62, under the proposal, further contributions are prohibited under such plans. The maximum annuity is an annuity with a level annual benefit equal to the present-law dollar limit for defined benefit plans ($205,000 for 2013 but increasing to $210,000 for 2014) and payable in the form of a joint and 100 percent survivor benefit commencing at age 62 and continuing each year for the life of the individual and, if later, the life of the individual's spouse. The maximum annuity is designed to equal the maximum annuity that is permitted to be paid by a qualified defined benefit plan. The Treasury indicates that, using the 2013 defined benefit dollar limit and present law actuarial assumptions, the maximum permitted accumulation for an individual age 62 under this proposal is approximately $3.4 million.[378] For this purpose, tax-favored retirement plans include traditional IRAs (including SEPs and SIMPLE IRAs), Roth IRAs, qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans.

The limitation is determined as of the end of a calendar year and applies to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees are required to report each individual'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 an individual who is under age 62, the accumulated account balance is converted to an annuity payable at 62, in the form of a joint and 100 percent survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For an individual who is older than age 62, the accumulated account balance is 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 age 62, and 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 an individual reaches the maximum permitted accumulation as of the end of a calendar year, no further contributions or accruals are generally permitted for subsequent calendar years, and any contributions made (or benefits accrued) for the subsequent calendar year are excess contributions (or accruals). However, an individual's account balances under defined contribution plans and IRAs can continue to grow with investment earnings and gains. In addition, if an individual's investment return for a year is less than the rate of return built into the actuarial equivalence calculation (so that the updated calculation of the individual's equivalent

[378] Department of Treasury, *General Explanation of the Administration's Fiscal year 2014 Revenue Proposals*, April 2013, p. 166

annuity as of the end of the calendar year is less than the maximum annuity permitted under a qualified defined benefit plan), additional contributions are permitted for subsequent calendar years. Furthermore, when the defined benefit dollar limit increases as a result of a cost-of-living adjustment, the maximum permitted accumulation automatically increases as well, potentially allowing a resumption of contributions or accruals for an individual who previously was subject to a suspension of contributions and accruals by reason of the overall limitation.

If there is a contribution made (or an additional benefit accrued) for a year that is an excess accumulation, the tax consequence of the excess accumulation is similar to the consequence of an excess deferral under present law. Thus, the individual must include the amount of the resulting excess accumulation in current income but is allowed a grace period during which the individual can withdraw the excess contribution or excess accrual from the account or plan in order to comply with the limit. If the individual does not withdraw the excess contribution or an amount equal to the actuarial present value of excess accrual, then the excess amounts and attributable earnings are 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).

Effective date.−The proposal is effective with respect to contributions and accruals for taxable years beginning on or after January 1, 2014.

Analysis

General policy considerations in limiting aggregate tax-favored retirement accumulations

Advocates for this proposal argue that the present-law limitations on retirement plan contributions and benefits do not adequately limit the extent to which an individual can accumulate amounts in tax-favored arrangements through the use of multiple plans. They point out that accumulations through multiple plans can be considerably in excess of amounts needed to fund reasonable levels of consumption in retirement and can be well beyond the level of accumulation that justifies tax-favored treatment of retirement accounts. They argue that the accumulations allowed under the present-law defined benefit dollar limit are sufficient to provide a substantial level of consumption in retirement. Individuals who have exceeded the limit on accumulations under the proposal are not prevented from continuing to increase their retirement savings; they are only prevented from increasing their retirement savings on a tax-favored basis.

Others argue that a cap on aggregate tax-favored retirement savings would limit the present-law consumption-tax treatment for retirement savings accumulated in IRAs and employer-sponsored tax-favored retirement plans. Limiting the aggregate value in retirement plan accumulations eliminates this consumption tax treatment for additional saving. Further, present-law tax deferral for retirement savings allows a form of "income averaging" across one's lifetime, which some argue provides a fairer distribution of lifetime tax burdens. A cap on aggregate retirement saving cuts back on this feature of present law. Advocates for the proposal respond that, while these elements of present-law taxation of retirement saving are desirable to a degree, it is not unreasonable to impose limits on tax-favored treatment once the objective of a financially secure retirement has been achieved.

Finally, some point out that one reason employers provide for contributions (or benefit accruals) for rank-and file-workers under their tax-favored retirement plans is to allow contributions to be made (or benefits to accrue) under the plan for business owners and other highly compensated employees without violating plan nondiscrimination requirements. Thus, if the retirement plan accumulations of a business owner or favored highly compensated employees reach the aggregate limit, the employer may have less incentive to provide contributions (or benefit accruals) at the same level for rank-and-file. Some argue that small business owners in that situation are likely to terminate the plan. Others argue that employers maintain retirement plans to recruit employees and not simply to allow tax-favored retirement savings for business owners and highly compensated employees.

Administrative complexities and burdens with respect to the limit

In general

Although the basic concept of limiting an individual's aggregate retirement benefits from all tax-favored plans may be appropriate and the amount needed to provide a joint and survivor annuity with annual payments equal to the defined benefit plan limit ($205,000 for 2013 but increasing to $210,000 for 2014) may be a reasonable limit, the actual application of this limit annually to aggregate retirement accumulations of all individuals presents complexities, uncertainties, and potential burdens for both plan sponsors and individuals. As a practical matter, these complexities and burdens are likely to result in higher administrative costs, which can have a negative impact on net retirement savings for individuals generally, not just those at or near the limit. Also, as discussed below, the basic description of the proposal leaves some questions unanswered.

Further, some point out that the proposal does not prevent excessive tax-favored retirement accumulations due to unusually favorable investment returns on contributions under defined contribution plans and IRAs made before reaching the limit.

Expressing the limit as an annuity commencing at age 62 rather than a single-sum value

In order to apply an aggregate limit to an individual's accumulated retirement savings (both in the form of individual accounts and benefits under a defined benefit plans), the limit and the relevant savings amounts must be expressed in a common form. Under the proposal, the limit is expressed as a level joint and 100-percent survivor annuity with an apparent uniform assumption that the individual is married to a spouse that is the same age.[379] One option is to convert the limit to a single sum and compare it to the sum of an individual's annuity benefits under any defined benefit plan (if any) converted to an equivalent single sum and any account-based savings of the individual. The other is to convert any account-based savings of an

[379] The Treasury estimate that, using present law actuarial assumptions and the 2013 defined benefit dollar limit, the maximum permitted accumulation for an individual age 62 under this proposal is approximately $3.4 million is consistent with this uniform assumption.

individual to an equivalent level joint and 100 percent survivor annuity, which is then added to any benefits of the individual under defined benefit plans, expressed in the same form.

The proposal takes the latter approach, that is the sum of an individual's accumulated account balances under defined contribution plans and IRAs is converted to an annuity payable at 62, in the form of a level joint and 100-percent survivor benefit, using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. The amount of this equivalent annuity is then combined with the individual's accumulated accrued benefits under defined benefit plans.

In theory, a similar computation is not needed for an individual's accumulated accrued benefits under defined benefit plans. However, accrued benefits under defined benefit plans are not expressed as joint and 100-percent survivor annuities commencing at age 62, with a spouse that is the same age (without regard to whether the employee is unmarried or has a spouse that is a different age). Most defined benefit plans do not even express the accrued benefit as a level joint and survivor annuity commencing at age 62. In particular, defined benefit plans commonly express the accrued benefit as a single life annuity commencing at a normal retirement age of 65, and hybrid plans generally express each individual's accrued benefit as a hypothetical account balance. Thus, the benefits under a defined benefit plan must also be actuarially converted to a level joint and 100-percent survivor annuity commencing at age 62, with a spouse that is the same age in order to compare the benefit to the limit as expressed under the proposal.

Some therefore argue that expressing the limit as a single-sum dollar amount equivalent to the defined benefit dollar limit payable as a joint and 100-percent survivor annuity commencing at age 62 with a same-age spouse would make the limit easier to understand and apply. Treasury could then calculate and publish annually the dollar limit for individuals at each age. Under this approach, accumulated accrued benefits under defined benefit plans would generally be converted to a single-sum value using the assumptions that apply in determining minimum lump sums under defined benefit plans. No conversion would be required for accumulations under defined contribution plans, IRAs, or hybrid plans under which the lump-sum benefit is the hypothetical account balance.

Variation in the aggregate limit when expressed as a present value

Because the limit is expressed as an actuarially equivalent annuity commencing at age 62, the limit (when expressed as an actuarial present value) for an individual for a taxable year is reduced for each year the individual is younger than age 62. Some argue that any aggregate limit applied to account balances under defined contribution plans and IRAs should the same for all individuals, regardless of an individual's age. Under the proposal, the annual change in the limit potentially causes individuals to be over the limit or under the limit to the extent the rate of return produced by their actual earnings experience is higher or lower than the assumed rate of return. Further, the variation in the corporate bond segment rates causes the limit to change from year to year even for individuals who are the same age. If corporate bond rates rise for some period, the limit (expressed as a present value) is reduced. Individuals who, before the interest rate rise, could have continued to make retirement plan contributions may be prevented from making additional contributions and taking advantage of the higher interest rates during the accumulation period for those contributions. Further, some suggest that, if interest rates rise, the

percentage of individuals subject to the limit may rise.[380] If interest rates subsequently go down, the individual may not be in a position to make further retirement plan contributions. For example, the individual may no longer be employed. Further, the effect of corporate bond interest rate changes adds complexity and causes the limit to be unpredictable, potentially making it difficult for individuals to make long range retirement savings decisions. Finally, being forced to assume a future rate of return (whether fixed or variable) fails to allow individuals to protect themselves against the potential for significant losses due to an economic down turn, such as in 2008, potentially causing a loss of principal (original contributions) as well as earnings.[381]

Others argue that any limit that applies to the aggregate amount of defined benefit and defined contribution plan retirement savings must be based on a future value because accruals under defined benefit plans are generally expressed as an annuity commencing at normal retirement age. Others also argue that, even if the limit only applied to defined contribution plan and IRA aggregate accumulations, it would be appropriate to take into account the time value of money in determining the limit, and thus, in the case of defined contribution plan account balances, to assume future earnings during years of accumulation until age 62. They further argue that the corporate bond segment rates are appropriate interest rates for assumptions as to such future earnings. The market forces that set corporate bond rates take into account expected future economic events, including the potential for economic downturns and upturns during the period of the bond. If an individual's average earnings on account balances over the period of prior accumulation are less than the assumed rate at any point in time, additional contributions can be made with respect to the individual (to the extent permitted under the annual contribution limits). Further, when interest rates are higher, individuals need a smaller aggregate accumulation to provide an annuity at age 62 equal to the defined benefit plan limit. If interest rates are lower, individuals can expect a lower future rate of return so the limit should be higher. If interest rates change, contributions for most individuals can be adjusted accordingly.

Some argue that, if an individual's aggregate defined contribution plan and IRA accumulations exceed the limit, and, accordingly, contributions for an individual are not allowed for a period, but then later the individual's aggregate account balances fall below the limit, the individual should be able to make up the prior missed contributions. Others respond that providing such a catch-up provision adds further complexity and increases the compliance burden on defined contribution plan administrators (and IRA trustees) as well as the IRS.

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[380] See discussion of effect of variable interest rates on the cap and the percentage of plan participants with benefits limited by the cap in Jack VanDerhei, "The Impact of Retirement Savings Account Cap," *Employee Benefit Research Institute Issue Brief No. 389*, August 2013.

[381] Generally, for a defined benefit plan, the risk of investment loss under the trust falls on the employer. However, for an employer that becomes insolvent, the plan may be forced into a distress termination and benefits ultimately provided are subject to the plan's funding level and the benefit guaranteed by Pension Benefit Guaranty Corporation.

Determining the account balance subject to the limit under defined contribution plans and IRAs

In the case of a defined contribution plan, an individual's accrued benefit is the individual's account balance under the plan. The proposal makes no apparent distinction between vested and forfeitable benefits. Thus, forfeitable amounts may cause an individual's savings to be at the limit, cutting off the individual's ability to make or receive additional contributions and accruals, and yet the individual may later forfeit some of those amounts on termination of employment. Some argue that individuals who have accumulated sufficient retirement benefits to be over this limit are unlikely to have nonvested benefits. In the unlikely scenario that a forfeiture does occur upon termination of employment with an employer, the individual may resume retirement plan accumulations with the next employer. Others respond that the very events that cause a job loss and benefit forfeiture may also seriously diminish the individual's ability or opportunity to make up the loss through further contributions or accruals.

Under the proposal, whether an individual's tax-favored retirement accumulations have reached the limit is determined "as of" the end of a calendar year. Thus, an individual's account balances under any defined contribution plans or IRA as of the end of the calendar year are taken into account. Some argue that the limit should simply be applied using the value on the last day of the calendar year, disregarding any contributions actually made after that day.

Others argue that the words "as of" should be interpreted in the same manner as for the annual defined contribution plan and IRA limits. Otherwise, plan contributions for an individual could be timed to delay the application of the limit for an individual for an additional year.[382] Under this approach, any elective deferrals relating to compensation that otherwise would have been received during the calendar year and thus are taken into account in applying the limits on elective deferrals are included in the account balance "as of" the end of the calendar year.[383] In addition, under this approach, any other contributions that are allocated to an individual's account under a plan as of a date during a calendar year for purposes of the annual defined contribution plan limit are taken into account in applying the aggregate retirement accumulation limit under the proposal even if the contribution is not actually made until after the end of the calendar year. Similarly, under this approach, the IRA contributions for a calendar year that are not actually contributed to the IRA until after the end of calendar year would be taken into account. Some point out, however, that, in at least some cases, under this approach, individual account balances "as of" the end of a calendar year cannot be determined until near the end of the immediately following calendar year.

Finally, regardless of the approach taken with respect to contributions made for a year but not actually made until after the end of the year, to prevent avoidance of the limit, account

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[382] For example, contributions for a calendar year that would result in the individual reaching the limit for a year could be made after the end of that calendar year and then contributions for the immediately following calendar year could be made during such immediately following year.

[383] Elective deferrals deducted from compensation paid for the last pay period ending in a calendar year may not be actually be contributed until the beginning of the following calendar year.

balances "as of" the end of the calendar year need to be interpreted to take into account any 60-day rollover amounts that are not actually in any account on the last day of the calendar year.[384]

Determining the accrued benefits under defined benefit plans subject to the limit

By specifying that the plan annually reports the amount of each individual's accrued benefit, the proposal indicates that the aggregate limit only takes into account the individual's accrued benefit and not subsidies provided through optional forms of payment. Some point out that, because, under present law, benefit subsidies are taken into account in applying the defined benefit plan limit, there is an apparent inconsistency in basing the limit on the defined benefit dollar limit but not taking into account potential benefit subsidies to which an individual may be entitled.[385] They further point out that, if benefits subsidies to which an individual is potentially entitled are not taken into account, the individual's aggregate tax-favored retirement accumulations may be below the limit, allowing additional contributions or accruals for the individual, but then the individual may actually receive a much more valuable form of benefit under the defined benefit plan which, if taken into account, would have prevented both additional accruals and contributions.

Others respond that it would be inappropriate to take into account potential benefit subsidies in applying an aggregate limit. They argue that the risk that an individual will never receive a benefit subsidy is far greater than any risk of forfeiture of the accrued benefit. In many cases, it is not possible to know whether the individual will ever meet the conditions for the subsidy until very near the time of commencement of benefits. If the subsidy is taken into account in applying the accumulated benefit cap, then an individual may be treated as having accrued a benefit that the individual never receives, either because the individual never fulfills the conditions for entitlement to payment in that form or does not elect that form of payment. In the meantime, contributions for the individual to defined contribution plans or IRAs may not be allowed. In addition, taking all possible subsidized benefits into account in determining the individual's aggregate retirement benefits subject to the limit makes the proposal even more complicated.

Ability to stop future accruals or contributions

A basic premise of the proposal is that when the aggregate retirement plan accumulations and accruals reach the limit, no further contributions will be made (and no further benefits will accrue) with respect to that individual. However, some point out that participation in a defined benefit plan is generally not a choice by an employee. Once an employee is a participant, accruals under a defined benefit plan happen automatically. An employee accrues rights to plan

[384] Unless these rollover contributions are taken into account, the limit on accumulations could be avoided by annually withdrawing all amounts in IRAs before the end of a calendar year and recontributing the amount (within 60 days) in the following calendar year.

[385] In the case of an individual who actually receives a joint and 100 percent survivor annuity under a defined benefit plan with an annual benefit of $210,000 (for 2014), the survivor benefit is by definition a benefit subsidy. The accrued benefit payable in any other form is limited to the actuarial equivalent of a straight single life annuity with an annual benefit of $210,000 (for 2014).

benefits by virtue of being a member of the defined coverage group under the plan and fulfilling the requirements for entitlement to accrual of benefits under the plan's benefit formula. Similarly, nonelective contributions under a defined contribution plan are based on a plan formula and defined coverage group, and are not permitted to be subject to an employee's election. Generally, under a defined contribution plan, only elective deferrals and, in some cases, after-tax employee contributions are elective on the part of the employee.

Some argue that an employer can design its retirement plans so that accruals and allocations of employees do not exceed the limit. An employee's right to an allocation or accrual can be conditioned on aggregate benefits under all plans of the employer not exceeding the aggregate limit. Further, under most plans, after termination of employment, an individual has an opportunity to elect to receive a distribution of benefits. The amount of such distribution can be retained (and included in gross income) or rolled over to an IRA or another tax-favored retirement plan. Thus, to the extent that an individual's accumulated tax-favored retirement savings include amounts held in IRAs or under the retirement plans of another employer, the individual can correct for any excess defined benefit plan accrual or defined contribution plan allocation under the plan of the individual's current employer by withdrawing amounts from IRAs or plans of prior employers.[386]

Reporting defined contribution plan and IRA account balances and contributions, and corrections for excess contributions

The proposal requires that defined contribution plans report to the individual and the IRS each individual's account balance as of the end of the year as well as the amount of any contribution to the individual's account for the plan year.[387] If contributions made after the last day of the calendar year that are allocated retroactively as of a date during the calendar year are taken into account in determining if the limit is exceeded for such previous year or in determining the amount of excess contributions made for such previous year (if such year follows a year in which the limit is exceeded), as discussed above, some defined contribution plans may not be able to report the account balance subject to the limit, or contributions for the year, until near the end of the following calendar year. As a result, under the proposal, an individual may not receive the information needed to take a corrective distribution of excess amounts until after the date by which the corrective distribution must be made (generally April 15 following the calendar year for which the contribution was made). Thus, some argue that individuals should have additional time to withdraw amounts needed to correct any excess.

Others argue that the limit could be applied on the basis of the actual account balance on the last day of the year, without regard to later contributions made for the year, and contributions would only be reported for the calendar year during which the contributions were actually made, This approach would be simpler for plans to administer and would not require additional time for correction, but, as discussed above, would potentially allow contributions to be timed to allow

[386] Some point out that plans are not required to allow withdrawals before the plan's normal retirement age by individuals who have terminated employment.

[387] Under present law, section 408(i) requires annual reporting for IRAs.

contributions for an additional year after the limit would have been reached (under the other interpretation of "as of" the end of the calendar year).

Reporting of accumulated benefits and annual accruals under defined benefit plans.

The proposal requires defined benefit plans to report the amount of the accrued benefit and the accrual for the year, payable in the same form. Some argue that this annual reporting of accrued benefits and annual accruals for individuals (whether expressed as an annuity or an actuarial present value) presents a much more significant burden than reporting by defined contribution plans and may not be possible for some defined benefit plans. Most plans do not make a precise calculation of each participant's accrued benefit each year. Instead, a calculation is generally made when a participant actually applies for benefits. Generally, a participant's benefits are calculated under a formula that takes into account the individual's age, years of service, and compensation, but may also take into account other factors. Most plans obtain this information when the individual applies for benefits and selects a particular form of payment. For many plans, this information is not readily available for an annual calculation, particularly in the timeframe needed to comply with the reporting requirement under the proposal.[388]

Moreover, as discussed above, plans do not express the accrued benefits in terms of a level joint and 100 percent survivor annuity commencing at age 62, using a uniform assumption that an individual has a spouse that is the same age. Except in the case of certain hybrid plans, plans do not express accrued benefits as a lump sum dollar amount. Thus, the plan would need to annually convert each accrued benefit and annual accrual into either an actuarially equivalent level joint and 100 percent survivor annuity commencing at age 62 or a current lump sum.

Application of limit only to highly compensated employees

Some suggest that the complexities and burdens of the proposal could be reduced by only applying the limit with respect to aggregate accumulations of individuals who are current or former highly compensated employees of an employer. With this change, employer-sponsored plans would only be required to provide annual reports of account balances and contributions (or accrued benefits and accruals) for highly compensated current or former highly compensated employees. However, IRA trustees do not generally maintain records of the plan that was the original source of funds in the IRA, and the trustee would not have a record of whether the source of the funds was a plan under which the IRA owner had been a highly compensated employee. In addition, not all employers have a reason to identify highly compensated employees for their plans, for example, governmental plans which are not subject to the nondiscrimination requirements.

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[388] Plans need a certain amount of data to calculate minimum funding obligations but this information is generally based on a reasonable estimates of participants' benefits rather than individualized benefit determinations. Section 105 of ERISA requires that, every three years, defined benefit plans provide a benefit statement to each active participant who has a vested accrued benefit. These benefits are also permitted to be based on reasonable estimates. However, a benefit statement must be provided to a participant who requests one and the information is not permitted to be based on reasonable estimates.

Conclusion

Some argue that the complexities of applying a combined limit that takes into account both defined benefit accruals and defined contribution plans and IRA account balances outweigh the conceptual arguments in favor of this approach. They argue that a simpler, more administrable approach might be to provide a fixed dollar limit on aggregate defined contribution and IRA accumulations that does not take into account accrued benefits under defined benefit plans.[389] They argue that not only would this approach be easier for individuals to understand and for plans to administer, it would also be easier for the IRS to monitor compliance. The IRS would only need to match reported account balances to a fixed limit. If there is a concern that aggregate accumulations of younger individuals could reach this limit and then continue to grow, a provision requiring withdrawal of a portion of amounts in excess of the limit could be included.

Others argue that fairness concerns compel taking into account accruals under defined benefit plans despite the administrative complexities.[390] Otherwise, individuals who participate in defined benefit plans in addition to defined contribution plans are able to accumulate greater retirement savings than individuals who only have the opportunity to participant in defined contribution plans.[391]

Some suggest that a return to approaches similar to those under prior law could be considered. As under prior law, a combined limit could be imposed on annual contributions and accruals under the defined contribution and defined benefit plans of an employer.[392] Alternatively, as under prior law, an additional tax could be imposed on annual distributions in excess of a specified amount supplemented by a tax on excess accumulations remaining at the

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[389] This approach is suggested in John A. Turner, David D. McCarthy, and Norman P. Stein, Closing a Tax Loophole: Defined Contribution Plans with Very Large Individual Account Balances, available upon request from John A Turner, jaturner49@aol.com

[390] In the case of certain hybrid plan designs that express the benefit as an accumulated account balance, some argue that the accumulation under such a plan is nearly identical to an accumulation under a defined contribution plan, and should be subject to any aggregate limit on defined contribution plan accumulations. Not taking into account defined benefit plans accumulations under any aggregate limit produces anomalous results in certain situations. For example, if an individual whose aggregate accumulations under defined contributions plans are less than the limit receives a lump sum from a defined benefit plan and rolls it over to an IRA, the value of the accruals under the defined benefit plan are included in applying the limit with respect to further contributions to defined contribution plans and IRAs. If, instead, the individual does not commence distributions or commences distributions in an annuity form, the accumulations in the defined benefit plan are disregarded.

[391] For example, if defined contribution plan and IRA accumulations of a self-employed individual without employees reaches the limit, the individual can establish a defined benefit plan and continue accumulating retirement savings.

[392] Prior to 2000, there was a combined limit under section 415 that took into account the contributions and accruals for a participant under both defined contribution plans and defined benefit plans of an employer. The combined limit generally limited aggregate contributions and accruals to a total of 125 percent of the separate defined benefit and defined contributions limits. This combined limit was repealed by section 1452 of the Small Business Job Protection Act of 1996 (Pub. L. No. 104-188), effective for limitation years beginning after December 31, 1999.

individual's death.[393] Similar to the reasons for the proposal for an aggregate limit on tax-favored retirement accumulations, the reason cited for imposing additional taxes on excess distributions and excess accumulations under prior law was that "Congress believed that there was no need to permit a participant to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits."[394]

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[393] Prior to 1997, under then section 4980A, there was also a 15-percent excise tax on aggregate distributions from tax-favored retirement plans to the extent they exceeded $155,000 (for 1996) with an increase in the estate tax at death equal to 15 percent of the remaining retirement plan accumulations to the extent they exceeded the present value of an immediate life annuity of the same annual dollar amount, using the individual's age at the time of death. Section 4980A was repealed by section 1073(a) of the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34), effective for distributions received after December 31, 1996, and, for the increase in the estate tax, for decedents dying after that same date.

[394] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Pub. L. No. 99-514)* (JCS-10-87), May 1987, p.755. Similarly, the combined limit on contributions and accruals was included in ERISA to prevent an employer from establishing multiple plans (either multiple plans of the same type (defined contribution or defined benefit) or different types of plans) as a way of avoiding the limits. The limits were intended to "operate as an overall ceiling on the maximum benefits the employee can obtain under all plans." H.R. Report No. 93-779, 93rd Cong, 2nd Sess. p. 120. The reason for repealing the taxes on excess distributions and excess accumulations, as reflected in Joint Committee on Taxation, *General Explanation of the Tax Legislation Enacted in 1997* (JCS-23-97), December 1997, p. 263, was that Congress believed that the limits on contributions and benefits applicable to each type of vehicle are sufficient limits on tax-deferred savings. There was also a concern that additional penalties would deter savings and penalize favorable investment returns. As reflected in Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 1996, p. 171, one of the reasons cited for repealing the combined limit under section 415 was that Congress believed that the combined limit may have had the effect of discouraging employers from providing adequate retirement benefits to their employees.

PART XV − REDUCE THE TAX GAP AND MAKE REFORMS

A. Modify Reporting of Tuition Expenses and Scholarships on Form 1098-T

Present Law

Eligible educational institutions that enroll individuals for any academic period are required to furnish, both to the IRS and to the student, an information return known as Form 1098-T. Among the information the educational institution is required to remit is (i) either the aggregate amount of payments received, or the aggregate amount billed, for qualified tuition with respect to the student to whom the Form 1098-T pertains; and (ii) the aggregate amount of grants received by such individual for payment of costs of attendance that are administered and processed by the institution during the calendar year.

Description of Proposal

The proposal would require educational institutions to report amounts paid, and not amounts billed, on the Form 1098-T.

The proposal also would 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 a 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.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2013.

Analysis

The present-law reporting requirements that are related to qualified tuition expenses are misaligned with the requirements of the tax benefits related to qualified tuition expenses. Tax benefits for tuition expenses (*i.e.*, the deduction for tuition, the Hope credit, the American opportunity tax credit, and the lifetime learning credit) are benefits related only to the amount of tuition actually paid by the taxpayer. Thus, an educational institution's report of the amount billed to the taxpayer does not necessarily provide either the taxpayer or the IRS with useful information regarding the taxpayer's eligibility for these credits. Additionally, by listing only the amount billed, taxpayers may be confused and believe that this amount is the relevant value on which to claim the tax benefits for tuition, leading to unintentional errors on taxpayer returns. The proposal's requirement to limit reporting to the amount paid by the student both serves to provide the IRS and the taxpayer with relevant information and decrease potential errors on tax returns.

Opponents of the proposal may argue that educational institutions may find it costly and burdensome to track the amount a student has paid, rather than the amount billed to the student, for purposes of their tax filing obligation.

Because a taxpayer's qualified tuition expenses for purposes of the education deduction and credits is reduced by the amount of any scholarship received by the taxpayer, the proposed expansion of the scholarship reporting requirements could potentially improve taxpayer compliance with respect to those benefits.

Opponents of the proposed expansion of the scholarship reporting requirements might argue that the proposal imposes an extra cost on organizations that might not be able or willing to incur that cost, potentially decreasing the overall level of scholarships given by the newly covered organizations.

B. Make E-filing Mandatory for Exempt Organizations

Present law

In general

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[395] states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007.[396] Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

Present law requires the Secretary to issue regulations regarding electronic filing and specifies certain limitations on the rules that may be included in such regulations.[397] The statute requires that Federal income tax returns prepared by specified tax return preparers be filed electronically,[398] and that all partnerships with more than 100 partners be required to file electronically. For taxpayers other than partnerships, the statute prohibits any requirement that persons who file fewer than 250 returns during a calendar year file electronically. With respect to individuals, estates, and trusts, the Secretary may permit, but generally cannot require, electronic filing of income tax returns. In crafting any of these required regulations, the Secretary must take into account the ability of taxpayers to comply at a reasonable cost.

The regulations require corporations that have assets of $10 million or more and file at least 250 returns during a calendar year to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. In determining whether the 250 return threshold is met, income tax, information, excise tax, and employment tax returns filed within one calendar year are counted.

Tax-exempt organizations

Most tax-exempt organizations are required to file annual information returns in the Form 990 series. Since 2007, the smallest organizations − generally, those with gross receipts of less than $50,000 − may provide an abbreviated notice on Form 990-N, sometimes referred to as an "e-postcard." Which form to file depends on the annual receipts, value of assets, and types of activities of the exempt entity. The Forms 990, 990-EZ, and 990-PF are released to the public on DVDs.

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[395] Pub. L. No. 105-206.

[396] The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, p. 6.

[397] Sec. 6011(e).

[398] Section 6011(e)(3)(B) defines a "specified tax return preparer" as any return preparer who reasonably expects to file more than 10 individual income tax returns during a calendar year.

In general, only the largest and smallest tax-exempt organizations are required to electronically file their annual information returns. First, as indicated above, tax-exempt corporations that have assets of $10 million or more and that file at least 250 returns during a calendar year must electronically file their Form 990 information returns. Private foundations and charitable trusts, regardless of asset size, that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns.[399] Finally, smaller organizations that file Form 990-N (the e-postcard) also must electronically file.[400]

Description of Proposal

The proposal extends the requirement to file electronically to all tax-exempt organizations required to file statements or returns in the Form 990 series. The proposal also requires that the IRS make such forms publicly available in a machine readable format in a timely manner.

Effective date.−The proposal is effective for tax years beginning after the date of enactment, except that Treasury is expected to permit transition relief for smaller organizations or others for whom the requirement would constitute an undue hardship in the absence of additional transition time. In addition, the IRS in its discretion may delay the effective date up to three years for the filing of reports of unrelated business taxable income, Forms 990-T.

Analysis

Arguments in favor of requiring all tax-exempts to file electronically include not only the general savings and efficiency increases that are realized by the government when electronic filing increases, but also several arguments related to the need for an effective means of providing public oversight of the nonprofit sector. According to a national clearinghouse for data on the U.S. nonprofit sector, there are 1.537 million tax-exempt organizations that are registered with the IRS as of May 2013, including section 501(c)(3) public charities, private foundations, and other entities exempt under other provisions of the Code. They account for over nine percent of all wages and salaries paid in the United States, and represent 5.5 percent of GDP.[401]

With respect to the savings and efficiency arguments, electronic filing generally increases efficiency because it enables the IRS to make use of its computer infrastructure to target returns with audit potential. This focus, in turn, allows the IRS to utilize its resources in areas in which such efforts would be most fruitful. Improved utilization of audit resources is valuable for both

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[399] 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.

[400] See Form 990-N, "Electronic Notice for Tax-exempt Organizations not Required to File a Form 990 or 990-EZ."

[401] National Center for Charitable Statistics of the Urban Institute, available at http://nccs.urban.org/statistics/quickfacts.cfm.

the nonprofit and for-profit sectors. More importantly, the savings in processing costs are well-documented. Proponents may point to the Government Accountability Office ("GAO") study which reported that electronic filing has enabled the IRS to close two paper processing centers and save 1,600 staff years.[402] The significant cost savings in processing a return have also been observed by the Treasury Inspector General for Tax Administration, reporting that a paper return is over nine times more costly to process than a return submitted electronically and has a far greater error rate.[403] Such savings are available regardless of the content of the particular returns. Opponents may note that savings to the government are at the expense of increased costs for the exempt organizations that are newly subject to the e-filing mandate but not eligible for free filing. In response, proponents may counter that private organizations already provide access to filing software for exempt organizations, free to those organizations with gross receipts less than $100,000.[404]

The arguments in favor of e-filing that are specific to tax-exempt organizations relate to the need for general public oversight of the exempt sector and a means to assist potential donors in evaluating a particular organization. Present law enables the public to know whether an entity purporting to be an exempt organization is in compliance with the Code by mandating that the IRS make certain documents available and by requiring exempt organizations to make returns available for public inspection for a period of three years after the filing due date for such returns.[405] Implementation of this proposal could assist States effectively discharge their oversight responsibilities with respect to charities.

Supporters of the proposal contend that currently available information is inadequate to permit effective use of the information. In complying with its obligations to disclose returns filed by exempt organizations, the IRS releases all returns in the same format. The data captured on paper returns is not computable, *i.e.*, it is not machine-manipulable, but the data on returns that were e-filed is computable. In order to conform the format of all returns, the IRS prepares hard copies of the e-filed returns rather than digitizing the paper returns and copies images of all of the documents to DVD in a read-only format.

Instead, "open data" for the philanthropic sector is necessary to enable donors to navigate the data made public.[406] In order to be considered "open data," the information must be available

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[402] Government Accountability Office, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings* (GAO-07-27), November 2006, p.3. A "staff year" refers to the equivalent of time worked by one full-time member of the staff in one year.

[403] It costs the IRS only $0.35 to process an e-filed return, versus $2.87 for a paper filed return, according to a study. Higher rates of processing errors on paper returns are attributed to the need to input information into IRS computers. Inspector General for Tax Administration, Department of Treasury, *Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs* (TIGTA 2009-40-130), September 10, 2009.

[404] See National Center for Charitable Statistics of the Urban Institute, available at http://efile.form990.org.

[405] Sec. 6104(d).

[406] See generally The Aspen Institute, "Information for Impact: Liberating Nonprofit Sector Data," 2013.

without regard to legal restrictions on use, such as those imposed by intellectual property laws, and must be both accessible (available without the impediment of a paywall or encryption) and computable (available for download in a standardized non-proprietary format). As a result, certain organizations acquire the DVD, and key in the data in order to provide the desired manipulable data base of the exempt organization data.

C. 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 Reports[407]

Description of Modification

Present law

In the case of a plan subject to the vesting requirements under the Employee Retirement Income Security Act of 1974 ("ERISA"), the plan administrator is required to file a registration statement with the IRS with respect to any plan participant who (1) separated from service during the year and (2) has a vested benefit under the plan, but who was not paid the benefit during the year (a "deferred vested" benefit).[408] The registration statement must include the name of the plan, the name and address of the plan administrator, the name and taxpayer identification number of the separated participant, and the nature, amount, and form of the participant's deferred vested benefit. This information is generally subject to the confidentiality protections applicable to returns (including information returns) and return information. However, the IRS is required to provide this information to the Social Security Administration ("SSA"), which, in turn, provides this information to the participant (or the participant's beneficiary) when the participant (or beneficiary) becomes eligible for Social Security benefits.[409]

The required registration statement was previously included as an attachment to Form 5500, Annual Return/Report of Employee Benefit Plan. However, information on Form 5500 is now required to be available to the public, and, under the current filing system, Forms 5500 are filed electronically and posted on the Internet. The required registration statement is therefore provided by filing Form 8955-SSA, Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits, with the IRS.[410]

Modification of proposal

The fiscal year 2013 budget proposal is modified by providing the IRS with authority to require Form 8955-SSA to be filed electronically with the IRS, without regard to whether the filer is required to file at least 250 returns during the calendar year.

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[407] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 582.

[408] Code sec. 6057(a). Under Code section 6057(e) and ERISA section 105(c), similar information must be provided to the separated participant.

[409] Code secs. 6057(d) and 6103(l)(1)(B) and sec. 1131 of the Social Security Act.

[410] The IRS has issued proposed regulations to require that, if a filer (that is, plan administrator or employer) of Form 5500 or Form 8955-SSA is required to file at least 250 returns during a calendar year, the filer is generally required to file Form 5500 or Form 8955-SSA electronically. For purposes of determining whether a filer is required to file least 250 returns, all types of returns are aggregated, including, for example, income tax returns, employment tax returns and information returns. Prop. Treas. Reg. secs. 301.6057-3, 301.6058-2 and 301.6059-2, 78 Fed. Reg. 53704, 53707, 53708 (August 30, 2013).

Analysis

Electronic filing of Form 8955-SSA facilitates the IRS's processing and transmission to SSA of information about separated participants' deferred vested benefits, as well as the SSA's recording of the information in connection with the participants' Social Security record. Requiring electronic filing of Form 8955-SSA thus increases the likelihood that participants will receive the deferred vested benefits to which they are entitled, thus increasing retirement income security.

D. Impose Liability on Shareholders Participating in "Intermediary Transaction Tax Shelters" to Collect Unpaid Corporate Income Taxes

Present Law

Corporate stock vs. asset sales

When a purchaser of a corporate business buys the assets of the corporation that conducts the business (*i.e.,* the Target corporation), the purchaser obtains a basis in the purchased assets equal to the price paid, the Target corporation pays tax on any gain from the asset sale, and the Target corporation's earnings and profits are increased.

When the Target corporation then distributes the after-tax sales proceeds to its shareholders, the shareholders also pay tax on amounts paid out of the corporation's earnings and profits, and then on amounts received in excess of their stock basis. A corporate asset sale thus can result in two levels of tax.[411] By contrast, if the purchaser buys the corporate stock (rather than the assets of the corporation), the selling shareholders pay tax on any gain from their stock sale, no corporate tax is paid, there is no increase in corporate earnings and profits, and the bases of the corporation's assets are unchanged.

A purchaser typically would not pay as high a price for a Target corporation's stock as for its assets, assuming there would be a taxable gain on sale of the assets, because a stock purchase would not increase the basis of the assets without an additional corporate level tax.[412] Without increased asset basis, the Target corporation in the hands of the stock purchaser will have to pay greater corporate tax in the future, because lower asset basis produces less depreciation or amortization and greater gain on any sale of such assets. Thus, a purchaser may wish to acquire corporate assets. However, corporate shareholders may prefer to sell stock, because a sale of the assets would incur corporate level tax as well as tax at the individual level if the corporation is liquidated and the stock surrendered.

Intermediary transactions

In some cases, shareholders sell the stock of a Target corporation to an intermediary corporation, which corporation then causes the Target corporation to sell its assets to a purchaser that previously had been in negotiations with the shareholders. Alternatively, in some instances,

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[411] Secs. 337 and 338(a). Section 338 permits a corporate purchaser of 80 percent of the Target corporation stock to elect to obtain a purchase price basis for the assets inside the corporation, but the election generally requires the Target corporation in the hands of its corporate purchaser to incur corporate level tax on gain. If the selling shareholder is a corporation that has owned 80 percent of the stock of the Target corporation and the stock is sold to a purchasing corporation, then an election is available under which the selling corporation treats the transaction as an asset sale rather than a stock sale, and does not pay a separate tax on the sale of the stock. Sec. 338(h)(10). See regulations under section 336(e) for a similar election. Also, if the Target corporation itself has losses (including built-in losses in its assets) that would offset built-in gain on an asset sale, then an asset purchase may not cause a corporate level tax, due to the loss offset.

[412] A purchaser may prefer to acquire assets for non-tax reasons as well, such as not wanting to acquire other known or unknown liabilities of the Target corporation.

shareholders of a Target corporation that has already sold its assets and incurred potential tax liability for the tax year have been approached by, and sold the stock to, a purchaser corporation that pays them a price that explicitly assumes that a large portion of the corporate tax liability on the asset sale can be eliminated due to transactions intended to be entered by the corporation in the hands of the new stockholder. In some cases, the new stockholder causes the Target corporation to engage in transactions that it reports to IRS as creating losses or deductions that offset the gains from the asset sale. The IRS then challenges the validity of the losses or deductions and the Target corporation agrees to settle the case with agreed full tax liability, interest, and often penalties related to the claimed losses. However, the Target corporation has dissolved without sufficient assets to pay the IRS. In many cases the corporation has transferred its cash to the lender that provided the funds for the purchaser to acquire the stock at the price that assumed a reduction of corporate tax due.[413]

The net result of these transactions is that the selling shareholders obtain a purchase price for the Target corporation stock that explicitly assumes the corporate tax liability associated with any asset sale will be significantly reduced; the purchaser of assets obtains a stepped-up basis in the assets; the IRS prevails in asserting that corporate tax was due on the gain from the asset sale (often with penalties against the reporting position taken by the intermediary in claiming an offsetting loss), but no corporate tax is ever paid by the corporation (due to the corporation being insolvent).[414]

IRS Notices

Concerns about the ability to avoid tax by interposing an intermediary company in a sale of stock or corporate assets led the IRS to issue Notice 2001-16,[415] treating such transactions as tax shelters that are "listed transactions" for purposes of the tax shelter disclosure regime. That regime operates as a web of interlocking disclosure obligations for parties with disparate interests (*i.e.*, investors, promoters, and their advisers). An investor or participant in a transaction that may have a potential for tax avoidance is required to disclose that participation.[416] In identifying intermediary transactions as listed transactions, Notice 2001-16 also stated that the IRS may challenge such transactions under a number of approaches. These approaches include contending that the intermediary was an agent of the seller so that the asset sale should

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[413] See, *e.g.*, *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Salus Mundi Foundation v. Commissioner*, T.C. Memo 2012-61; *Feldman v. Commissioner*, T.C. Memo 2011-297; *LR Development Co. LLC v. Commissioner*, T.C. Memo 2010-203.

[414] See, *e.g.*, cases cited in Robert W. Wood, "The Boomerang Tax Problems of Midco Acquisition Part I," *Tax Notes*, October 8, 2012, pp. 211-214 and "The Boomerang Tax Problems of Midco Acquisition- Part II," *Tax Notes*, October 22, 2012, pp. 443-446; and Calvin H. Johnson, "Profits From Tax Evasion Under the Midco Transaction," *Tax Notes*, March 25, 2013, pp. 1485-1494.

[415] 2001-1 C.B. 730.

[416] The transactions with respect to which disclosure is required are "reportable" transactions. A transaction is reportable if it meets any of five criteria in regulations, one of which is its identification by the Secretary as a listed transaction. Treas. Reg. sec. 1.6011-4(b)(1).

be treated as occurring while the sellers owned the stock, that the intermediary was an agent of the buyer so that the buyer should be deemed to have bought stock not assets, or that the transaction is otherwise properly recharacterized (*e.g*. to treat the sellers of the stock as having sold assets or to treat the target as having sold assets while still held by the stock sellers). Alternatively, the Notice stated that the IRS may examine the intermediary corporation's consolidated group to determine whether it properly offset losses (or credits) against the gain (or tax) from the sale of assets.

Since its initial release, Notice 2001-16 has been revised twice by subsequent Notices in 2008,[417] due to concerns about how to distinguish an intermediary tax shelter transaction from other transactions in which corporate stock is sold and corporate assets also are sold, and how to define the persons who are the participants in the listed tax shelter transaction. In Notice 2008-20, the IRS acknowledged that identifying the transaction based on the role of an intermediary may result in over-disclosure or under-disclosure, depending on the circumstances of the transaction. The Notice identified four necessary components of an intermediary transaction tax shelter, but did not clearly require a pre-arranged plan to avoid or offset the corporate-level tax.[418]

Practitioners warned that unless a person is required to know or have reason to know of a plan to enter the listed transaction, the broad sweep of Notice 2008-20 could create inadvertent participants in intermediary transaction tax shelters.[419] It was noted that an asset purchaser may not know whether the stock will be sold within a period after the asset purchase, nor would a stock seller know what assets may be sold after the stock purchase. It was thought that in the face of uncertainty, some taxpayers may "file a protective disclosure or request a ruling on the merits of its transaction."[420]

Ten months after issuing Notice 2008-20, the IRS superseded it in Notice 2008-111. This most recent Notice defines an intermediary transaction to require four specific components in addition to a plan: 1) a Target corporation must have a net taxable built-in gain in its assets; 2) at least 80 percent of Target stock (by vote or value) must be disposed of by Target's shareholders within a 12 month period; 3) either within 12 months before; simultaneously, or within 12 months after the stock disposition date (when 80 percent of the stock was disposed of), at least 65 percent of the value of Target's assets are disposed of in transactions in which gain is recognized; and 4) at least half of Target's built in gain tax that would otherwise result from the disposition is purportedly offset or avoided or not paid.

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[417] Notice 2008-111, 2008-2 C.B. 1299, superseding Notice 2008-20 2008-6 I.R.B. 406 and clarifying Notice 2001-16, 2001-1 C.B. 730.

[418] As noted by the New York State Bar Association, the original Notice 2001-16 referred to a plan. It was not clear the extent to which the Notice 2008-20 incorporated this concept. See New York State Bar Association, Tax Section, "Re: Notice 2008-20 (Intermediary Tax Shelters)," May 23, 2008, pp. 5-7, available at http://www.nysba.org/AM/Template.cfm?Section=Home&template=/CM/ContentDisplay.cfm&ContentID=16428.

[419] See, *e.g.*, New York State Bar Association, Tax Section, op. cit.

[420] *Ibid.*

Under Notice 2008-111, only a person that enters into a transaction pursuant to a plan (the Plan) is engaging in the listed transaction. This occurs if a person knows or has reason to know that the transaction is structured to effectuate the Plan. In addition, any person that is at least a five-percent shareholder (by vote or value), or that is an officer or director of Target, engages in the transaction pursuant to a Plan if any of the following knows or has reason to know that the transaction is structured to effectuate the Plan: (i) any officer or director of Target, (ii) any of Target's advisors engaged by Target to advise Target or the relevant shareholder with respect to the transaction, (iii) any advisor of that shareholder engaged by that person to advise it with respect to the transaction.

The Notice provides safe harbor exceptions for (1) any seller of stock traded on an established securities market that did not hold more than five percent of such stock, (2) any seller of stock, any Target corporation, or any intermediary corporation, if after the acquisition of Target stock the acquiror is the issuer of stock or securities that are publicly traded on an established securities market in the United States, or is consolidated for financial reporting purposes with such an issuer, and (3) any acquiror of assets if the only Target assets it acquires are either (i) securities traded on an established securities market that represent a less-than-five-percent interest in that class of security, or (ii) assets that are not securities and that do not include a trade or business.

Section 6901

Section 6901 of the Code provides that the amounts of certain liabilities shall (with certain exceptions) be asserted, paid, and, collected in the same manner and subject to the same provisions and limitations as in the case of taxes with respect to which the liabilities were incurred. Among these liabilities is the liability, at law or in equity, of a transferee of property of a taxpayer, in respect of a tax imposed by the income tax provisions of the Code.

Section 6901 states that the term transferee includes donee, heir, legatee, devisee, and distributee.

The Supreme Court has interpreted this language (in the predecessor 1939 Code provision) to provide a Federal procedure for collection, but to require state law to govern in determining whether there is a liability, at law or in equity, of a transferee to any creditor, including the IRS.[421]

When the IRS attempts to collect the tax from transferees of the corporate assets (including from the selling shareholders on the argument that the sales price represents a transfer of corporate assets), the IRS must comply with a combination of Federal procedure and State

[421] *Commissioner v. Stern*, 357 U.S. 30 (1958). The case involved an IRS attempt to obtain payment of a decedent's income tax liability from the decedent's widow, as transferee of proceeds of a life insurance policy the decedent had purchased. The court found that state law did not impose such transferee liability absent a finding that the decedent had intended to defraud the IRS by purchasing the insurance policy. Three justices dissented, stating their view that liability for federal taxes should be determined by uniform principles of federal law, in the absence of the plainest congressional mandate to the contrary. The dissent concluded that the legislative history fell short of a congressional mandate to that effect. 357 U.S. at 48-50.

substantive law. Federal tax law establishes the right to seek the tax from the transferor. In the case of transferee liability, Federal law requires the IRS to bear the burden of proof that the transferee has transferee liability. However, the extent to which a creditor (the IRS) has rights against the transferred property under applicable State law determines a transferee's substantive liability. If such rights are established, the IRS may initiate a transferee liability proceeding against the transferee, either by suit against the transferee, or by issuing a notice of transferee liability.[422] The limitations period for asserting transferee liability is computed by reference to the last date on which the tax could be asserted against the transferor, plus one year. If the initial transferee has since transferred the property, the Code permits an additional year in which tax can be asserted against a secondary transferees (that is, a transferee of the transferee), but in no event is the limitations period extended for more than three years.[423]

State law

The applicable State law for a shareholder or purchaser for corporate tax purposes is likely to be the law of the State of incorporation, although sales contracts may require application of law of another jurisdiction. Most states permit recovery of debt from a transferee of a debtor under a statute modeled after the Uniform Fraudulent Transfer Act ("UFTA") or its predecessor, the Uniform Fraudulent Conveyance Act, first adopted in 1918 as a codification of longstanding common law principles of creditor rights.[424] Those statutes provide a basis for establishing transferee liability on a theory that the transfer was fraudulent if it was adverse to the interest of creditors. Under the UFTA, in order for a creditor to collect a debt from a transferee of the debtor, the creditor must establish the existence of the debt, that a transfer (defined to include incurring a new debt) occurred, and that the transfer either was (1) actually intended to defeat ability of creditors to collect the debt, or (2) was for less than adequate consideration under conditions from which constructive intent to defraud can be inferred. In addition, UFTA requires one of three conditions be met to support a finding of constructive fraud. Those three conditions are insolvency of the debtor (either at the time of, or as a result of, the transfer), debtor intent to incur more debt than he could repay, or insufficient assets with which to operate his business as a result of the transfer. Some states permit creditors to recover debts that arose after the transfer in question; others limit recovery to debts that were in existence as of the date of the transfer. In jurisdictions with the latter version of the statute, taxes arising from the transaction that itself constitutes the fraudulent transfer will be considered future debts, not eligible for recovery by the creditor.

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[422] Secs. 6901-6905.

[423] Sec. 6901(c).

[424] General information about the UFTA, its history and the extent to which it has been adopted by the states is available at http://uniformlaws.org/Act.aspx?title=Fraudulent%20Transfer%20Act. See National Conference of Commissioners on Uniform State Laws, "Uniform Fraudulent Transfer Act" (1984), available at http://www.uniformlaws.org/shared/docs/fraudulent%20transfer/ufta_final_84.pdf.

Judicial decisions

The cases in which the IRS has challenged intermediary transactions by attempting to establish the liability of the selling shareholder or acquiring party have produced mixed results. In one case, the IRS challenged such a transaction involving a sale of stock prior to a sale of assets as a sham lacking economic substance, and the court agreed, with the result that the ultimate purchaser of the assets was treated as not obtaining a stepped-up basis for the acquired assets. In that case, the buyer and seller had initially discussed a purchase transaction but had been unable to agree on price due to seller's reluctance to incur corporate level tax on an asset sale, and the buyer's reluctance to pay the same price for stock as for assets. The intermediary transaction was suggested by the buyer's tax advisor. The sale of stock and the purchase of assets occurred within 24 hours of one another, and the intermediary corporation obtained the funds for the stock purchase from a financing that was 100 percent secured by the buyer's funds.[425]

In another case, the IRS succeeded in imposing transferee liability on shareholders who entered into a purported stock sale of a corporation that already had sold all its assets. The court in that case applied the Wisconsin UFTA as the basis for transferee liability.[426]

In a number of cases in which the IRS pursued transferee liability, the IRS has been unsuccessful in attempts to recover tax. When the intermediary corporation has dissolved with insufficient funds to pay the tax liability on the asset sale, the IRS has attempted to pursue either the selling shareholders (who obtained from the intermediary an enhanced purchase price for the stock) or the ultimate asset purchaser (who acquired the assets of the intermediary corporation and obtained a stepped up basis) to pay the tax that the corporation in the hands of the intermediary did not pay.[427] The IRS has lost a number of such cases on grounds that former shareholders who sold stock, or subsequent asset holders who acquired assets, do not meet standards for transferee liability under applicable State law in the absence of a showing of intent to defraud the IRS. Some cases also have concluded that an IRS assertion of transferee liability based on a determination of corporate tax made after a corporation has dissolved occurred too late because applicable State law of fraudulent transfers restricted recovery to debts that were in existence at the time of the transfer. Taxes determined after the transfer were considered to be future debts and therefore not recoverable.

In a recent case, however,[428] the Second Circuit Court of Appeals vacated an opinion of the Tax Court that had concluded the shareholders in an intermediary case did not have actual or constructive knowledge of the entire series of transactions. The Second Circuit Court concluded

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[425] *Enbridge Energy Co., Inc. v. United States*, 553 F. Supp. 2d 716 (S.D. Texas 2008), aff'd *per curiam*, 2009 WL 3753540 (5th Cir. 2009).

[426] *Ray Feldman , Transferee, et. al. v. Commissioner*, T.C. Memo 2011-297.

[427] See, *e.g.*, *Starnes v. Commissioner*, 680 F. 3d 417 (4th Cir. 2012), *LR Development Co, LLC v. Commissioner*, T.C. Memo 2010-203.

[428] *Diebold Foundation, Inc., Transferee, v. Commissioner*, 2013 WL 6015660 (2d Cir. 2013).

that the shareholders' conduct evinced constructive knowledge under New York State law and that there was a fraudulent conveyance under the New York Uniform Fraudulent Conveyance Act. Applying such New York State law, the court held that in substance the corporation had sold its assets and made a liquidating distribution to the shareholders that left the corporation insolvent. The court remanded the case to the Tax Court to determine whether the shareholder foundation was a transferee within the meaning of section 6901, whether the foundation to which it distributed its assets (the appellee in the case) was a transferee of a transferee under section 6901, and the applicable statute of limitations. At the same time, the Second Circuit court also stated that it followed the conclusions of cases in the First and Fourth Circuit Courts of Appeals, that Federal law should not be used to determine the characterization of a transaction first (*e.g.*, to collapse a transaction under Federal substance over form principles) and then state law afterwards applied to that characterization.[429]

Description of Proposal

The proposal would impose liability on certain shareholders who enter into an intermediary transaction tax shelter. The proposal applies only to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50 percent) in the stock of a C corporation[430] 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 (1) the value of the total proceeds received by the shareholder for the disposed of stock or (2) 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. The shareholder liability would be 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 to any shareholder, 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.

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[429] The court cited *Frank Sawyer Trust of May 1992 v. Commissioner,* 712 F. 3d 597 (1st Cir. 2013) and *Starnes v. Commissioner*, 680 F. 3d 417 (4th Cir. 2012). In *Frank Sawyer Trust*, while following state law, the First Circuit did remand the case to the Tax Court to examine issues under the "less than adequate consideration" prong of Massachusetts law that had not been addressed, and that could lead to liability for a shareholder under Massachusetts law even in the absence of actual knowledge of the scheme.

[430] A C corporation is a corporation subject to the provisions of subchapter C of the Code, generally subject to tax at the entity level (unlike an S corporation that is not taxed at the entity level).

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 its assets. The proposal would 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.

Effective date.−The proposal would be effective upon date of enactment.

Analysis

The proposal would give statutory authority to the Treasury Department to define an intermediary transaction tax shelter covering certain sales of business assets within a year prior to or following a stock sale, and would impose liability on selling shareholders for unpaid corporate tax on such sales of the business assets of their corporation that constitute an intermediary transaction tax shelter. Only those selling shareholders who have entered into a transaction as part of a "plan" would be liable.

A premise of the proposal is that the Treasury Department will successfully define an intermediary transaction tax shelter in regulations and that IRS will be able to prove the existence of a plan. It is not clear whether the proposal would create a different burden of proof that will make it easier for the IRS to prove the existence of a plan in which a shareholder participated.[431]

The results in cases in which the IRS has challenged intermediary transactions, both in asserting the corporate tax and in attempting to establish the transferee liability of the selling shareholder or acquiring party, demonstrate the difficult nature of the factual questions inherent in establishing the existence of a plan.

Adoption of the proposal might possibly deter the entry of the types of transactions that the IRS has been targeting. Selling shareholders might require an indemnity from any stock purchaser against any liability they might incur under the new rule. Under present law, a stock purchaser normally requires representations and indemnities that the purchased corporation does

[431] As one example, a majority shareholder might sell his stock to a purchaser that anticipates losses apparently not known to the selling shareholder. In an unrelated transaction occurring within 12 months, the purchaser sells the corporate assets and files a consolidated return in which any gain is offset by the losses incurred after the acquisition. The circumstances under which the selling shareholder would be considered a participant in an Intermediary Transaction Tax Shelter if the IRS should successfully challenge the losses and the corporation should fail to pay the tax due are unclear.

not have undisclosed tax liabilities and has adequately reserved for any potential liabilities. Under the proposal, selling shareholders could require reciprocal indemnifications relating to any transactions occurring within a year of the sale, over which they do not have control. It is possible that this might deter purchasers who intend to enter possibly questionable transactions in an attempt to offset gain from an asset sale and report no tax liability. At the same time, another effect might be to increase transaction costs on transactions not involving the types of cases that are targeted.

If transactions of the targeted type continue, there also is a possibility that the IRS could fail in its attempt to prove shareholder participation in a plan, on the same factually difficult basis that it has lost in some attempts to prove an intent to defraud the IRS. The proposal might be strengthened if presumptions were adopted, such as deeming that when shareholders explicitly are offered a price for their stock that assumes a significant reduction in corporate tax due to unspecified acts or circumstances of the purchaser, they are participants in a plan. The proposal states that Treasury has the authority to define an Intermediary Transaction Tax Shelter. It is not clear whether this authority is intended to include the authority to define a plan and to define participation in the plan, (including by the creation of irrebuttable presumptions of knowledge from one person to another).[432]

Nevertheless, some might contend that the statute or Treasury should not provide conclusive presumptions regarding participation in a plan, but that these determinations should be made based upon all the facts and circumstances and using applicable state law. If this remains the underlying approach of the proposal, it is unclear what its effective scope would be.

Another legislative approach that might be considered would be to expand the liability of material participants in listed transactions to impose substantive joint and several liability for corporate tax and penalties on promoters and facilitative lenders if an entity enters into a tax shelter transaction such as a listed transaction and is insolvent when the tax, interest, and any penalties with respect to that transaction is due. If limited to listed transactions, the effectiveness of such an approach would depend upon the ability of IRS to identify as listed transactions the relevant acts of the corporation, and to prove that the particular transaction entered was a listed transaction. If broadened to cover any transaction for which tax liability is established and the liable person is a promoter or material participant, without regard to prior identification by the IRS as a listed transaction, some might contend that the effect could be too harsh. Factual issues could continue to exist regarding whether a particular person was a "promoter" or a "material participant."

[432] Notice 2008-111 includes a presumption that a five-percent or greater shareholder, or an officer or director, knows of a plan if certain officers or advisors of the corporation know of the plan.

E. Implement a Program Integrity Statutory Cap Adjustment for Tax Administration

Description of Modification

The fiscal year 2013 budget proposal is modified by adjusting 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. This proposal would fund approximately $400 million in new enforcement and compliance initiatives in fiscal year 2014, provide additional funding for new enforcement and compliance initiatives in each fiscal year between 2015 and 2018, and fund all of the new initiatives and inflationary costs via cap adjustments through fiscal year 2023. The total projected cost of the proposal is $14 billion through fiscal year 2023.

F. Restrict Access to the Death Master File

Present Law

A list of deceased individuals, known as the Death Master File ("DMF") comprises information obtained by the Social Security Administration ("SSA") from a variety of sources other than State governmental bodies.[433] Updated weekly, the DMF contains the full name, Social Security Number (SSN), date of birth, and date of death for the decedents listed. This information is distributed through the Department of Commerce and is widely available on many websites free or for a nominal fee.

The DMF was first created and published as part of a settlement of a lawsuit under the Freedom of Information Act of 1966 ("FOIA"), in which an individual attempted to determine whether pension benefits were being fraudulently claimed on behalf of individuals who had died.[434] The suit was resolved with a consent judgment entered in 1980, which remains in effect. The scope of the data included on the list was narrowed when data received from States was specifically exempted from FOIA in 1983. Social Security officials maintain that have no legal grounds on which to depart from continuing to compile and publish the data the agency receives from sources other than States. The agency has not sought modification of the order.[435]

Description of Proposal

The proposal restricts immediate access to the DMF to those users who legitimately need the information for purposes of fraud prevention. Release of the DMF to all other users is delayed for three years.

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

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[433] Since 1983, subsection (r) to section 205 of the Social Security Act has required that SSA collect death information from States to update program records and exempts such information from States from FOIA and the Privacy Act. 42 U.S.C. sec. 405(r)(6).

[434] Thomas Hargrove and Isaac Wolf, "Fraud-fighter from Stuart, who won access to master death file, now says it's abused," *Scripps Howard News Service*, available at http://www.tcpalm.com/news/2011/nov/15/fraud-fighter-from-stuart-who-won-access-to-file/?print=1.

[435] Testimony of David F. Black, General Counsel, Social Security Administration before the House Committee on Ways and Means, Subcommittee on Social Security May 8, 2012, available at http://www.ssa.gov/legislation/testimony_050812.html. In his testimony, Mr. Black noted that the Department of Justice had advised SSA that there was no exemption to the FOIA or the Privacy Act that would justify withholding the data covered by the court-approved consent decree.

Analysis

As of December 18, 2013, the House of Representatives and the Senate passed legislation (expected to be signed by the President) that included a provision which is substantially similar to the President's fiscal year 2014 budget proposal.[436]

[436] H.J. Res. 59, 113th Cong.

G. Provide Whistleblowers with Protection from Retaliation

Present law

Under section 7623 of the Internal Revenue Code ("the Code"), individuals who submit information leading to detection of underpayment of tax or to detection, trial, and punishment of persons guilty of violating internal revenue laws, may file a claim for an award of 15 to 30 percent of recovered funds resulting from such action.

Though other statutes such as the False Claims Act[437] currently protect some individuals from employer retaliation, those who file claims under the Code are not explicitly afforded these same protections.

Description of proposal

The proposal would explicitly protect individuals who file claims under section 7623 of the Code. These protections would be consistent with those currently available under the False Claims Act and may expose employers to substantial damages for punishing individuals whose conduct is protected, for example through reinstatement, back pay plus interest, and compensation for other special damages including litigation costs and reasonable attorneys' fees.

Analysis

Though the IRS generally does not reveal individual claimants' identities, there may be instances in which it is necessary to do so. For example, it may be necessary to identify the individual as a witness in an underlying tax case. As a result, a lack of explicit protection against retaliation may discourage individuals from providing information that may lead to detection of underpayment of tax or other violations of the Code. To the extent that this is the case, explicit protection of these individuals against retaliation may encourage more individuals to provide information and file claims.

[437] 31 U.S.C. sec. 3730(h)(2).

H. Provide Stronger Protection from Improper Disclosure of Taxpayer Information in Whistleblower Actions

Present law

Section 6103 of the Internal Revenue Code ("the Code") treats tax returns and tax return information as confidential. Returns and return information are not to be disclosed unless such disclosure is specifically authorized in section 6103 or other provision of the Code.[438] Section 6103(p) institutes a number of safeguards on procedures to request and disclose tax return information and recordkeeping of these functions in order to further protect confidentiality of returns and return information on certain disclosures. In addition, criminal and civil sanctions apply to the unauthorized disclosure or inspection of returns and return information.[439]

Under section 6103(h), the Whistleblower Office of the IRS may disclose tax returns and tax return information to whistleblowers and their legal representatives in a whistleblower administrative proceeding by written agreement with the IRS under section 6103(n). Under section 6103(n), the Whistleblower Office may disclose tax returns and tax return information to certain other persons who are involved in processing, storage, transmission, and reproduction of such returns and return information, as well as other services for the purpose of tax administration. Currently, the disclosures of information to persons who have entered into written agreements under 6103(n) are subject to section 6103(p) safeguarding requirements, but those under 6103(h) are not.

Description of Proposal

The proposal would subject disclosure of tax returns and tax return information to whistleblowers and their legal representatives in a whistleblower administrative proceeding to the same safeguarding requirements that currently exist for disclosure of tax returns and tax return information under 6103(n) agreement. In addition, the proposal extends penalties for unauthorized inspections and disclosures of tax return information to whistleblowers and their representatives. The proposal will not affect the ability of an individual to participate in a whistleblower administrative proceeding or to file a claim for a whistleblower award.

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[438] See section 6103(c) (disclosure by taxpayer consent); 6103(d) (disclosure to State tax officials); 6103(e) (disclosure to persons having material interest); 6103(f) (disclosure to committees of Congress); 6103(g) (disclosure to the President and certain other persons); 6103(h) (disclosure to Federal officers and employees for tax administration purposes); 6103(i) disclosure to Federal officer and employees for administration of Federal laws not relating to tax administration); 6103(j) (statistical use); 6103(k) (disclosure of certain returns and return information for tax administration purposes); 6103(l) (disclosure for purposes other than tax administration); 6103(m) (disclosure of taxpayer identity information); 6103(n) (tax administration contractors); and 6103(o) (disclosure of return and return information with respect to certain taxes).

[439] Secs. 7213, 7213A, and 7431.

Analysis

Currently, disclosure of tax returns and tax return information to whistleblowers and their legal representatives under section 6103(n) are subject to the safeguards enumerated in section 6103(p). However, disclosures of information under 6103(h) are not. If subjecting such disclosures to safeguarding protections does not prevent disclosures of information that may be beneficial or necessary to the proceedings, protecting these disclosures through the requirements enumerated in 6103(p) should facilitate the goals of fair and safe tax administration.

I. Index All Penalties to Inflation

Present Law

A number of penalty provisions in the Internal Revenue Code (the "Code") currently contain fixed penalty amounts that are not indexed to inflation.

Description of Proposal

The proposal would index all penalty amounts to inflation and round the indexed amount to the next hundred dollars.

Analysis

If inflation leads to higher prices in the economy over time, a fixed nominal penalty amount will decline in real, inflation-adjusted terms. Assuming penalties are instituted in order to encourage compliance, the decrease in the inflation-adjusted value of penalties over time may erode the incentive to comply with the associated tax.

J. Extend Paid Preparer EIC Due Diligence Requirements to the Child Tax Credit

Present Law

Eligibility requirements for certain refundable credits

Two refundable credits available to individuals use both income level and the presence and number of qualifying children as factors in determining eligibility for the credit: the child tax credit[440] and the earned income credit ("EIC").[441] Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income ("AGI"), if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,300 (for 2013). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

An individual may claim a child tax credit of $1,000 for each qualifying child under the age of 17,[442] provided that the child is a citizen, national, or resident of the United States.[443] The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.[444] If the resulting child credit exceeds the tax liability of the taxpayer, the taxpayer is eligible for a refundable credit (known as

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[440] Sec. 24.

[441] Sec. 32.

[442] Sec. 24(a).

[443] Sec. 24(c).

[444] Sec. 24(b).

the additional child tax credit)[445] equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). Prior to 2009, the threshold dollar amount was $10,000 and was indexed for inflation. For taxable years beginning after 2009 and before January 1, 2018, the threshold amount is $3,000, and is not indexed for inflation. The $3,000 threshold is currently scheduled to expire for taxable years beginning after December 31, 2017, after which the threshold reverts to the indexed $10,000 amount ($13,350 for 2013).

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

Diligence required by preparers returns for EIC claimants

Under Section 6695(g) of the Code, a penalty of $500 may be imposed on a person who, as a tax return preparer,[446] prepares a tax return for a taxpayer claiming the EIC, unless the tax return preparer exercises due diligence with respect to that claim. The due diligence requirements extend to both the determination of eligibility for the credit and the amount of the credit, as prescribed by regulations, which also detail how to document one's compliance with those requirements.[447] The position taken with respect to the EIC must be based on current and reasonable information that the paid preparer develops, either directly from the taxpayer or by other reasonable means. The preparer may not ignore implications of information provided by taxpayers, and is expected to make reasonable inquiries about incorrect, inconsistent or incomplete information.

The conclusions about eligibility and computation, as well as the steps taken to develop those conclusions, must be documented, using Form 8867, "Paid Preparer's Earned Income Credit Checklist," which is filed with the return.[448] The basis for the computation of the credit must also be documented, either on a Computation Worksheet, or in an alternative record containing the requisite information. The preparer is required to maintain that documentation for three years.

The penalty may be waived with respect to a particular return or claim for refund on the basis of all facts and circumstances. The preparer must establish that he routinely follows reasonable office procedures to ensure compliance. The failure to comply with the requirements

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[445] Sec. 24(d).

[446] Sec. 7701(a)(36) provides a general definition of tax return preparer to include persons who are compensated to prepare all or a substantial portion of a return or claim for refund, with certain exceptions.

[447] Treas. Reg. sec. 1.6695-2(b).

[448] If the return preparer electronically files the return or claim for the taxpayer, the Form 8867 is filed electronically with the return. If the prepared return or claim is given to the taxpayer to file, the Form 8867 is provided to the taxpayer at the same time, to submit with the return or claim for refund.

must be isolated and inadvertent.[449] The enhanced duties of due diligence required with respect to the EIC do not extend to other refundable credits.

Description of Proposal

The proposal requires paid tax return preparers who prepare federal income tax returns on which a child (or additional child) tax credit is claimed to meet due diligence requirements similar to those applicable to returns claiming an earned income tax credit. The proposal anticipates that the checklist presently required by regulations will be adapted by the IRS to address both the child tax credit and the EIC and to highlight differences between the two credits. In adapting the checklist, the IRS is to ensure that it imposes minimal additional burden on taxpayers and paid preparers.

Effective date.−The proposal is effective for tax years ending after December 31, 2013.

Analysis

Refundable credits have been the subject of compliance concerns. A high rate of erroneous claims has been observed, even on those returns prepared with the assistance of a paid preparer.[450] The penalty for failure to comply with the EIC due diligence requirements was first enacted in 1997, at a rate of $100 per return. In that same year, Congress authorized special appropriations for five years to fund IRS initiatives to improve compliance with the EIC, strengthen enforcement, conduct public outreach, and research causes of erroneous filings.[451] The penalty was increased from $100 to $500 in 2011.[452] Other legislative responses to such concerns imposed special rules on the taxpayers claiming the credits and required the IRS to assess the risk of making improper payments in the revenue programs.[453]

The rationale for a due diligence requirement on preparers is that it discourages preparers from advising or assisting taxpayers in claiming credits that cannot be sustained, thus reducing the incidence of erroneous claims. Because the criteria for EIC and the child tax credits have similar features, some suggest that similar rules, and penalties for failure to comply with the rules, should apply to both credits. Thus, the rationale for this proposal depends upon the belief that the existing EIC due diligence penalty has had the desired effect.

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[449] Treas. Reg. sec. 1.6695-2(d).

[450] See TIGTA, *The Internal Revenue Service Disallowed Erroneous First-Time Homebuyer Credits Totaling $1.6 Billion; However, Its Examination Resources Could Have Been Used More Effectively*, (TIGTA 2012-41-013), February 3, 2012; TIGTA, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims,* (TIGTA 2009-40-057), March 31, 2009. There have also been extensive reports of fraudulent claims for the refundable credits.

[451] Sec. 5702, "The Balanced Budget Act of 1997," Pub. L. No. 105-33.

[452] Sec. 6695(g), amended in 2011.

[453] Improper Payments Elimination and Recovery Act (IPERA) of 2010, Pub. L. No. 111-204, 124 Stat. 2224.

Although the IRS has issued periodic reports on its compliance initiatives with respect to the credit, there is little information specifically about the frequency with which the penalty for lack of due diligence has been imposed. As a result, opponents of the proposal may argue that the lack of information about use of the penalty precludes drawing conclusions about whether the caliber of return preparation services received by claimants of the EIC has improved and, to the extent it has improved, whether the improvement can be credited to the due diligence requirements. Infrequent use of the penalty may be due to improved caliber of preparer services, but it may also be that the clients likely to attempt to make a false claim have avoided diligent preparers. Anecdotal reports suggest that those claimants inclined to make an improper claim for a refundable credit utilize return preparation services less frequently than in the past, thus avoiding the need to answer the due diligence questions for the preparer. Others may use "do-it-yourself" products, either online or in purchased software, in which the claimant alters answers that may be part of a software product until the taxpayer arrives at the desired tax result.

Improved return preparer services may also be due to many factors other than the threat of the penalty, such as the recent focus on registration and training of paid preparers, or the public outreach undertaken by the IRS to educate the public about the credit and how to select a return preparer.[454] Increasing the requirements for well-trained, and diligent preparers may not deter the unscrupulous preparer, but may increase the costs of services from the diligent. In response, proponents may argue that because the EIC program remains a high-level compliance risk,[455] and the taxpayers who are eligible for the EIC are particularly vulnerable to poorly trained or unscrupulous preparers, measures that may improve the quality of the services provided by return preparers are desirable.

Opponents of this proposal may also note that the criteria for the two credits are not identical, which may make development of a clear checklist that facilitates compliance difficult. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, even though the allowances are excluded from gross income for individual income tax purposes. They are not considered earned income for purposes of the additional child tax credit because the income is not included in taxable income. On the other hand, persons claiming the child credit or additional child tax credit are already required to prepare schedules that document eligibility for the credits. If the preparers who assist with completion of such schedules are already appropriately exercising care to assure the accuracy of those schedules, the proposal should not result in additional burden.

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[454] The IRS website includes a page devoted to the EIC, and includes links to an "EITC assistant" to help people determine their eligibility for the credit, a page on how to select a professional, and how to prepare for a meeting with a preparer. That same page includes links to help determine eligibility for other tax credits or deductions that may be relevant to those eligible for the EIC. Available at http://www.irs.gov/Individuals/EITC-Home-Page--It%E2%80%99s-easier-than-ever-to-find-out-if-you-qualify-for-EITC.

[455] See TIGTA, Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs are Unreliable, (TIGTA 2013-40-015), January 31, 2013. Appendix IV of the report reflects the risk assessment of EIC by Treasury that was included in its FY2011 Annual Financial Report.

Finally, some may note that the proposal, by focusing on penalizing behavior fails to address a more significant factor contributing to erroneous refundable credits, which is the inability of the IRS to check income tax returns against third-party information returns during the filing season. As a result, the IRS must decide whether to issue refunds on the basis of unverified information. The National Taxpayer Advocate has criticized what she characterized as the "Pay Refunds First, Verify Eligibility Later" approach and recommended a change in the current approach to return processing.[456] Under that proposal, reconsideration of the timing and sequence of filing third-party information returns as well as the filing deadlines for income tax returns is required.

[456] See National Taxpayer Advocate, vol. 1, 2009 Annual Report to Congress, 338-345.

K. Extend Internal Revenue Service (IRS) Authority to Require a Truncated Social Security Number (SSN) on Form W-2

Present Law

Section 6051(a) of the Code generally requires that an employer provide a written statement to each employee on or before January 31st of the succeeding year showing the remuneration paid to that employee during the calendar year and other information including the employee's social security number ("SSN"). The Form W-2, Wage and Tax Statement, is used to provide this information to employees and contains the taxpayer's SSN, wages paid, taxes withheld, and other information.

Other statements provided to taxpayers, such as Forms 1099, generally issued to any individual or unincorporated business paid in excess of $600 per calendar year for services rendered, are subject to rules under section 6109 dealing with identifying numbers. Section 6109 requires that the filer provide the taxpayer's "identifying number" which is an individual's SSN except as otherwise specified in regulations. Accordingly, for some statements, the Treasury Department has the authority to require or permit filers to use a number other than a taxpayer's SSN.

Description of Proposal

The proposal revises section 6051 to require employers to include an "identifying number" for each employee, rather than an employee's SSN, on Form W-2. This change will permit the Treasury Department to promulgate regulations requiring or permitting a truncated SSN on Form W-2, as is currently provided under section 6109.

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

Analysis

In a press release detailing its annual "Dirty Dozen" list of tax scams, the IRS listed tax-related identity theft as the number one tax scam for 2013.[457] In response to the growing problem of identity theft related tax fraud, the IRS recently issued proposed regulations to create a new taxpayer identification number known as the IRS Truncated Taxpayer Identification Number, or TTIN.[458] The TTIN provides an alternative to using an SSN such that the filer of certain information returns is able to use a TTIN on the corresponding payee statements to identify the individual being furnished a statement. The TTIN displays only the last four digits of an individual's identifying number.

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[457] IRS Press Release, IR-2013-33, March 26, 2013, available at http://www.irs.gov/uac/Newsroom/IRS-Releases-the-Dirty-Dozen-Tax-Scams-for-2013.

[458] REG-148873-09, available at http://www.irs.gov/irb/2013-07_IRB/ar10.html. These regulations make permanent the pilot programs announced in Notices 2009-93 and 2011-38, which authorize filers of certain information returns to voluntarily truncate an individual payee's nine digit identifying number on specified paper payee statements.

Form W-2 could not be included in these proposed regulations because of the current statutory requirement that the employee's SSN be provided on the form.

Proponents may argue that this proposal is needed to address the growing concern over identity theft in general and the growth in the number of such cases being handled by the IRS. In particular, the risk of identity theft from Form W-2 may be high because employers are required to file a Form W-2 for each employee who receives wages and because 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. Accordingly, proponents may argue that providing the IRS the authority to require or permit truncated SSNs on Forms W-2 will reduce the risk that the information could be stolen from a paper payee statement by identity thieves.

Some may argue that this proposal does not go far enough. Instead, truncated SSNs should be able to be used on all types of tax forms and returns provided to a taxpayer, employee or other recipient.[459] Additionally, some may argue that other TINs, including EINs, should be permitted to be truncated because certain payors' computer systems are not currently designed to distinguish between SSNs and EINs. Those payors may be unable to participate because they argue that the costs of updating software and records to limit truncation to individual SSNs poses an undue burden.[460]

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[459] Testimony of Jeffrey A. Porter, American Institute of Certified Public Accountants, Senate Committee on Finance, "Tax Fraud, Tax ID Theft and Tax Reform: Moving Forward with Solutions," April 16, 2013, available at http://www.finance.senate.gov/imo/media/doc/Porter%20Testimony1.pdf (noting as an example that the Form 8879, IRS E-file Signature Authorization, which is not filed with the IRS but exchanged back and forth between the taxpayer and the tax preparer is susceptible to theft).

[460] Francisca N. Mordi, Tax Counsel, American Bankers Association & David Wagner, Executive Managing Director, The Clearing House, "Comments on Proposed Regulations: IRS Truncated Tax Identification Numbers on Payee Statements," February 21, 2013, available at http://www.regulations.gov/#!documentDetail;D=IRS-2013-0004-0012.

PART XVI − SIMPLIFY THE TAX SYSTEM

A. Modify the Adoption Credit to Allow Tribal Determinations of Special Needs

Present Law

Present law provides a nonrefundable adoption credit with a maximum of $12,970 per eligible child (both special needs and non-special needs adoptions). The credit is adjusted annually for inflation. The credit is phased-out over a $40,000 range for taxpayers with modified adjusted gross income ("modified AGI") in excess of certain dollar levels. The adoption credit is phased out ratably for taxpayers with modified adjusted gross income between $194,580 and $234,580 (indexed for inflation) for 2013. The phaseout threshold is adjusted for inflation annually, but the phaseout range remains a $40,000 range. For purposes of the credit, a special needs adoption finalized during the taxable year is deemed to include $12,970 of eligible expenses associated with that adoption, regardless of whether expenses rose to that level. Taxpayers may claim the adoption credit against their alternative minimum tax liability.

A special needs adoption is the adoption of any child that (1) a State has determined that the child cannot or should not be returned to the home of his or her parents; (2) the State has determined that there exists with respect to the child a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical condition or physical, mental or emotional handicaps) because of which it is reasonable to conclude that such child cannot be placed with adoptive parents without providing adoption assistance; and (3) such child is a citizen or resident of the United States.

In general, unless specified in the Code, Indian tribal governments are not treated as a State for purposes of the Federal income tax.[461]

Description of Proposal

The proposal would amend the adoption tax credit to allow Indian tribal governments to make the determination that a particular child qualifies as a special needs adoption.

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[461] Section 7871 expressly provides that Indian tribal governments are treated as States for certain tax purposes. First, tribal governments may be recipients of deductible charitable contributions for income, estate, and gift tax purposes. Second, tribal governments are extended the treatment provided to States under the following excise taxes: tax on special fuels, manufacturers excise taxes, communications excise tax, and tax on use of certain highway vehicles. Special treatment relating to excise taxes is available to tribal governments only with regard to transactions involving the exercise of an essential governmental function, as described below, by the Indian tribal government. Third, taxes paid to Indian tribal governments are deductible for income tax purposes to the same extent as State taxes. Fourth, Indian tribal governments may issue tax-exempt bonds under certain conditions.

In addition, Indian tribal governments are treated as States for purposes of: (1) unrelated business income tax rules that apply to State colleges and universities, (2) treatment of amounts received under a disability and sickness fund maintained by a State, (3) the rules relating to tax-sheltered annuities,[461] (4) obligations issued on discount bonds, (5) the tax on excess expenditures to influence legislation, and (6) private foundation rules.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2013.

Analysis

The premise of the proposal is that the potential designation of an adoptive child as a special needs adoption should be available to all children. Present law prevents this designation in the case of the Native American children who are domiciled or reside within the reservation of tribes that have exclusive jurisdiction over custody proceedings under the Indian Child Welfare Act ("ICWA").[462] Because ICWA grants exclusive jurisdiction to Indian tribal governments over these proceedings, the State is precluded from designating Native American adoptive children as special needs.

Proponents of the proposal would argue that the adoption credit was enacted so as to mitigate the financial burden on families who adopted, and to reduce the number of children awaiting adoption. The rule divorcing actual expenses from the credit amount in the case of special needs adoptions provides an additional incentive for adoptive parents to adopt certain children who may otherwise be overlooked in the adoption process. Proponents would argue that there is no policy reason to disallow this designation for Native American children whose custody falls under the jurisdiction of a tribal government. Furthermore, proponents may argue that this disparity may discourage the adoption of those Native American children that would otherwise have been labeled special needs children, in favor of other children that are eligible for such a designation.

[462] 25 U.S.C sec. 1911(a).

B. Exclude Self-Constructed Assets of Small Taxpayers from the Uniform Capitalization Rules

Present Law

The uniform capitalization rules, which were enacted as part of the Tax Reform Act of 1986, require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[463] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

Section 263A provides a number of exceptions to the general uniform capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts;[464] such taxpayers are not required to include additional section 263A costs in inventory. Another exception exists for taxpayers who raise, harvest, or grow trees.[465] Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.[466] Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

Description of Proposal

The proposal expands the exception for small taxpayers from the uniform capitalization rules. Under this proposal, a taxpayer that has $10 million or less of average annual gross receipts is exempted from the application of section 263A with respect to costs incurred to produce real or personal property (including property produced for the taxpayer under contract) for use by the taxpayer in the taxpayer's trade or business.

Effective date.−The proposal is effective for costs incurred in taxable years beginning after December 31, 2013.

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[463] Sec. 263A.

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

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

[466] Sec. 263A(h).

Analysis

The uniform capitalization rules are relatively complex, and the proposal seeks to alleviate compliance burdens for small taxpayers by expanding the scope of properties that are exempted from the section 263A rules. Moreover, the proposal generally will increase cash flow for small taxpayers by allowing them to expense certain additional costs incurred to produce real or personal property, thereby freeing resources to pursue other activities or investments.

Some may argue that by expanding the exception from section 263A (*i.e.*, to those with $10 million or less of gross receipts), the exceptions for those who raise, harvest, or grow trees and those who incur qualified creative expenses are not needed (as the $10 million exception would exclude small taxpayers otherwise relying on this exception). For those taxpayers with more than $10 million in gross receipts, it could be reasoned that they have sufficient administrative resources to counter to the compliance burden and, thus, industry-focused exceptions are not warranted.

C. Repeal Technical Terminations of Partnerships

Present Law

Present law provides that a partnership is terminated under specified circumstances.[467] Rules are also provided for the merger, consolidation, or division of a partnership.[468]

A partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[469]

A partnership is treated as terminated if within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.[470] This is sometimes referred to as a technical termination. Under regulations, the technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.[471]

The effect of a technical termination is not necessarily the end of the partnership's existence, but rather, the termination of some tax attributes. Upon a technical termination, the partnership's taxable year closes, potentially resulting in short taxable years.[472] Partnership-level elections, even irrevocable ones, generally cease to apply following a technical termination.[473] A technical termination generally results in the restart of partnership depreciation recovery periods.[474]

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[467] Sec. 708(b)(1).

[468] Sec. 708(b)(2). Mergers, consolidations, and divisions of partnerships take either an assets-over form or an assets-up form pursuant to Treas. Reg. sec. 1.708-1(c).

[469] Sec. 708(b)(1)(A).

[470] Sec. 708(b)(1)(B).

[471] Treas. Reg. sec. 1.708-1(b)(4).

[472] Sec. 706(c)(1); Treas. Reg. sec. 1.708-1(b)(3).

[473] Partnership level elections include, for example, the section 754 election to adjust basis on a transfer or distribution, as well as other elections that determine the partnership's tax treatment of partnership items. A list of elections can be found at William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, fourth edition, para. 9.01[7], pp. 9-42 - 9-44.

[474] Although sec. 168(i)(7) provides that for purposes of computing the depreciation deduction, generally the transferee partnership is treated as the transferor when property is contributed in a tax-free transaction governed by section 721, it further provides that this rule does not apply in the case of a technical termination. Thus, the deemed contribution under Treas. Reg. sec. 1.708-1(b)(4) has the result of restarting depreciation periods applying the current adjusted basis of the property deemed contributed. See also William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, fourth edition, para. 13.05[2][k], pp. 13-33 - 13-37.

Description of Proposal

The proposal repeals the section 708(b)(1)(B) rule providing for technical terminations of partnerships. The proposal is effective for sales or exchanges after December 31, 2013.

The proposal does not change the rule of section 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Analysis

The premise of the proposal is that the present-law rule providing for technical terminations of partnerships is both a trap for the unwary and a manipulable tool for the well-advised. This is because its effects on partnership-level tax attributes such as elections, depreciation periods, and closing of the partnership taxable year can be either unanticipated by the unwary, or planned by the well-advised, in the event of a sale or exchange of partnership interests. Further, well-advised taxpayers may avoid the effects of a technical termination by structuring transactions as something other than a sale or exchange of the requisite percentage of partnership interests in profits and capital in a 12-month period. Under this view, any tax policy or tax administrability purpose served by the technical termination rule is outweighed by these disadvantages, so the rule should be limited or repealed.

The original purpose of the technical termination rule may have had largely to do with whether the partnership taxable year closed.[475] No reference is made in the 1954 legislative history to partnership level elections or tax attributes such as depreciation periods. The House bill provided that the taxable year of a partnership closes if there is "a sale of an interest of more than 50 percent in partnership capital or profits to persons not members of the partnership [and] [t]he partners may choose to ignore the termination if they wish to continue to the close of the normal partnership year."[476] The legislative history of the Senate bill provides that the bill includes the technical termination provision, and makes the termination of the partnership optional for the partnership.[477] The electivity was removed in conference; the conference report stated that "[s]ection 708 under the conference agreement provides that a sale or exchange within a 12-month period of 50 percent or more of the total interest both in partnership capital and partnership profits will be considered as a termination of a partnership. However, a disposition

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[475] The purpose may have been "to prevent trafficking in partnerships with advantageous taxable years and thereby to inhibit avoidance of the section 706(b) limitations on a partnership's ability to elect a taxable year other than that of its principal partners." William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, fourth edition, para. 13.03, p. 13-8.

[476] Report of the House Committee on Ways and Means to accompany H.R. 8300, H. Rep. No. 1337, 83rd Congress, 2nd Session, June 18, 1954, p. 388.

[477] Report of the Senate Committee on Finance to accompany H.R. 8300, S. Rep. No. 1622, 83rd Congress, 2nd Session, June 18, 1954, p. 388.

of such interests by gift or the death of a partner will not result in such a termination."[478] Commentary in 1954 shortly after enactment expressed concern about the effect of the technical termination rule, because of possible bunching of income from two partnership taxable years in the hands of the continuing partners in the event of the closing of the partnership taxable year.[479]

Today, the effects of a technical termination can be more extensive than simply closing the partnership taxable year. Potential negative tax results of unintentionally or unknowingly triggering a technical termination can include penalties for failure to file short-year partnership returns and reduced depreciation deductions due to spreading the adjusted basis of the assets (already reduced by prior depreciation) over a newly commenced recovery period rather than the remaining original recovery period.[480] For the well-advised, by contrast, some have suggested that a technical termination might serve as an alternative means of changing undesirable accounting method elections or depreciation methods while nevertheless minimizing the effect of section 481 adjustments that would otherwise be includable in income by amortizing the adjustment over the recovery period of the asset following the technical termination.[481] Commentators have described in detail methods for structuring transactions to avoid a technical termination (*e.g.*, by ensuring that only 49 percent is sold or exchanged within a 12-month period and the other one percent later, by transferring in a transaction that is not a sale or exchange, or by reducing the percentage of profits, or of capital, that is transferred below 50 percent).[482] Alternatively, the literature explains how taxpayers can affirmatively choose to structure a transaction to trigger a technical termination.[483]

Consequently, it could be argued that the technical termination rule has the effect of making other tax rules elective for well-advised partners of partnerships, even if these other tax rules were not intended by Congress as elective, and are not elective for taxpayers other than partners. It can be argued that this result is inconsistent with accurate income measurement and with Congressional intent relating to the other tax rules, and should be corrected by repeal of the technical termination rule.

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[478] Conference Report to accompany H.R. 8300, H. Rep. No. 1337, 83rd Congress, 2nd Session, July 26, 1954, p. 61.

[479] J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen, William C. Warren, "The Internal Revenue Code of 1954: Partnerships," *Columbia Law Review*, vol. 54, December 1954, pp. 1197-1198.

[480] See, *e.g.*, Vadim Blikshteyn (ed. Alan Wong), "The Partnership 'Technical Termination' Trap, *The Tax Adviser*, October 1, 2012, available at http://www.aicpa.org/publications/taxadviser/2012/october/pages/clinic-story-10.aspx .

[481] Lyn Afeman, "Technical terminations: tangible personal property depreciation issues," *The Tax Adviser*, June 1, 2007, reprinted at http://www.thefreelibrary.com/Technical+terminations%3A+tangible+personal+property+depreciation...-a0164947127 .

[482] See William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, fourth edition, para13.03[3], "Planning to Avoid (or Create) a Termination, pp. 13-17 - 13-21.

[483] *Ibid*.

Further, some advocates of repeal of the technical termination rule[484] have made the argument that the technical termination's result of closing the partnership taxable year for all partners has been supplanted by a subsequently-enacted statutory rule requiring the partnership's taxable year to conform to the taxable year of the majority interests in the partnership.[485] Thus, it is argued, if the original purpose of closing the partnership taxable year upon a technical termination was to coordinate the partnership's and the new partners' taxable years, that purpose is now served by a more specific statutory rule, and the technical termination rule can be abandoned. A related criticism is that the technical termination rule impacts continuing partners as well as incoming partners after the 50-percent ownership shift, even though there may be no change in the economic or business arrangement of those continuing partners.

Alternatively, the technical termination rule might be viewed as aimed at preventing the shifting of partnership tax attributes from old to new partners when there is a major shift in ownership. A shift in ownership as great as 50 percent (or greater) could be considered as giving rise to a new entity, so that tax attributes of the formerly-constituted partnership perhaps should not apply with respect to the new owners. Nevertheless, it can be said that the current rule has little or no such effect, and it is not evident that it ever had any such purpose. The current rule has not served to prevent shifts of preexisting partnership tax attributes to new partners, in that a technical termination can be avoided by well-advised new owners that want to retain preexisting partnership tax attributes. Moreover, a problem with the rule is that it allows continuing partners to circumvent Congressional intent with respect to the partnership's preexisting tax attributes. Thus, any analogy to other tax rules that prevent shifting of tax attributes to new owners is inapposite, and arguably does not support retention of the technical termination rule.

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[484] American Bar Association Tax Section, "Options for Tax Reform relating to Partnerships," letter of William M. Paul and Charles H. Egerton to Senator Max Baucus and Senator Orrin Hatch, Chairman and Ranking Member of the Senate Finance Committee, and The Honorable Dave Camp and The Honorable Sander Levin, Chairman and Ranking Member of the House Ways and Means Committee, December 2, 2011, pp. 12-13, available at http://taxprof.typepad.com/files/aba-partnerships.pdf

[485] Sec. 706(b)(4).

D. Repeal Anti-Churning Rules of Code Section 197

Present Law

In 1993, section 197 of the Code was enacted to provide a single uniform amortization period of 15 years for certain intangible assets acquired after the date of enactment (an "amortizable section 197 intangible"). Such assets include both previously unamortizable assets such as goodwill, going concern value, and other assets for which a taxpayer could not prove a value and a limited useful life that could be determined with reasonable accuracy, and assets that were previously amortizable under relevant judicial authority or Code provisions.

Section 197(f)(9) contains an "anti-churning" rule, intended to prevent taxpayers from obtaining 15-year amortization on goodwill, going concern value, or other previously unamortizable assets, by structuring a new acquisition of such an asset after the date of enactment. The provision excludes such an intangible asset from the definition of "amortizable section 197 intangible" if the taxpayer acquired the intangible asset after the date of enactment and (i) the intangible was held or used by the taxpayer or a related person at any time on or after July 25, 1991 and on or before the date of enactment, and as part of the transaction, the user of the intangible does not change, or (ii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used the intangible at any time on or after July 25, 1991 and on or before the date of enactment.

An exception applies if the person from whom the taxpayer acquired the asset elects, notwithstanding any other provision of Title I of the Code, to recognize gain on the disposition of the intangible and to pay a total tax on such gain equal to the highest rate of income tax applicable to such person.

For purposes of the anti-churning rule, a person is "related" to another person if, immediately before or after the acquisition of the intangible (I) the relationship of the persons is specified in section 267(b) or 707(b)(1)(substituting a more-than-20 percent relationship for more-than-50 percent) ,[486] or (II) the related person and such person are engaged in trades or businesses under common control within the meaning of subparagraphs (A) and (B) of section 41(f)(1).

A special rule for partnerships applies to any increase in basis of partnership property as a result of the certain acquisitions of partnership interests or distributions to partners under sections 732, 734, or 743. In such cases, determinations are made at the partner level and each partner is treated as having owned and used such partner's proportionate share of the partnership assets. [487]

Acquisitions by reason of death are excluded.

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[486] These provisions deny losses on sales between certain "related persons."

[487] Sec. 197(f)(9)(E).

An antiabuse rule also applies to any transaction one of the principal purposes of which is avoidance.

Description of Proposal

The proposal would repeal section 197(f)(9).

Effective date.−The proposal would be effective for acquisitions after December 31, 2013.

Analysis

The antichurning rules of section 197 are intended to prevent taxpayers from obtaining depreciation for assets that were not depreciable or amortizable prior to the enactment of section 197, through the use of sales and leasebacks or similar transactions, or post enactment transfers between related parties. The rules involve considerable complexity.

Whether an asset was not depreciable or amortizable under the law prior to enactment of section 197 is a factual question dependent upon the taxpayer's ability to prove a value and a useful life for the asset. The relevant standards were articulated in a Supreme court case[488] in which the court held (under the law prior to enactment of section 197) that an acquiror of a newspaper could amortize the customer base of that newspaper because it had met the burden of showing a rate of attrition of customers and the value attributable to them. The fact that replacement customers were added was not relevant. The IRS had contended that the customer base was the same as the goodwill of the newspaper, and not depreciable, but the court rejected this view.

The opinion stated:

"Although we now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the value of continued patronage, we do not mean to imply that the taxpayer's burden of proof is insignificant. On the contrary, that burden often will prove too great to bear…"[489]

In addition to the factual questions relating to whether an asset was amortizable or depreciable prior to enactment of section 197, applying the antichurning rule requires factual investigation of events dating to the period 1991-1993 (20 to 22 years ago). It is necessary to determine who held or used the asset at that time.

In addition to the above complexities, in the case of partnerships, the rules may impose difficult tracing and identification issues.

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[488] *Newark Morning Ledger Co. v. United States,* 507 U.S. 546 (1993).

[489] 507 U.S. 546, 566.

Given the complex factual and legal issues involved in applying the antichurning rules today, and that after 20 years it is arguable that many of today's assets are conceptually different than the assets of 20 years ago (even goodwill and going concern value), it is arguable that the simplification obtained by eliminating the rule at this point would not lead to significant abuse potential in structuring transactions to obtain amortizable basis. [490]

At the same time, if the antichurning rule were repealed, any business that was in operation in 1993 could now be sold and leased back, or transferred between related parties, and the buyer could amortize the goodwill where it might not previously have been able to do so. Furthermore, in cases in which the seller has significant losses or other items that might offset taxable income, a related party sale may have few constraints on the amount allocated to goodwill for which the buyer could claim amortization.

[490] See, *e.g.*, Romina Weiss, "Fifteen Years of Antichurning: It's Time to Make Butter," *Tax Notes*, January 12, 2009, pp. 227-239.

PART XVII − USER FEE

An analysis of the President's FY 2014 proposals on user fees can be found in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012.

PART XVIII − OTHER INCENTIVES

A. Replace the Consumer Price Index (CPI) with the Chained CPI for Purposes of Indexing Tax Provisions for Inflation

Present Law

Many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. 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, and is developed and published by the Department of Labor.

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

Description of Proposal

The proposal requires the use of the chained CPI-U (C-CPI-U) to index tax parameters currently indexed by the CPI-U. The C-CPI-U is developed and published by the Department of Labor, and differs from the CPI-U in that it accounts for the ability of individuals to alter their consumption patterns in response to relative price changes.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

Analysis

The CPI-U is a measure of the average change over time in the prices paid by urban consumers for a generally fixed market basket of consumer goods and services. Unlike the CPI-U, the C-CPI-U uses expenditure data in adjacent time periods to account for the effect of any substitution that consumers make across item categories in response to changes in relative prices. Thus, for example, if the price of pork rises but the price of beef does not, consumers are likely to shift their consumption towards beef and away from pork. The C-CPI-U accounts for this shift across item categories, and thus would measure inflation at a lower rate in this example than would the CPI-U. This feature makes the C-CPI-U a closer approximation to a "cost-of-living" index than the CPI-U. Because of this feature, many consider the C-CPI-U to be a better measure of inflation for purposes of inflation adjustments in the tax code. Use of the C-CPI-U raises revenue because it generally results in a lower measure of inflation than the CPI-U, thus causing smaller upward adjustments in the parameters that are indexed for inflation. In most cases, a lower value of an indexed parameter will result in greater tax liability.

Some complexities may arise in the use of the C-CPI-U. Because the expenditure data necessary to calculate the C-CPI-U is available only with a lag, the C-CPI-U is published

initially in preliminary form, then subject to two subsequent revisions. It will be necessary to specify which version of the index to use, and how to adjust for any subsequent revisions to the index. Certain provisions of the code, such as the refundable credit for coverage under a qualified health plan (sec. 36B), adjust parameters based on year over year inflation (as opposed to cumulative inflation from a base period value). For these provisions it would be necessary to use preliminary estimates of the C-CPI-U for the immediate preceding year and revised but not final estimates for the year prior to that, resulting in an inflation measure that could be consistently wrong when compared to final estimates for the C-CPI-U. In the general case of indexing parameters from a base year, the base year index values will be available in final form once a provision has been in effect for a couple of years. However, the parameters for a given year are generally determined by measuring the change in the index from the base period to the immediately prior 12-month period ending August 31. Thus, these parameters also will be determined by the use of preliminary or once-revised C-CPI-U figures, potentially introducing small errors in the determination of these parameters.

ESTIMATED BUDGET EFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL [1]

Fiscal Years 2013 - 2023

[Millions of Dollars]

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
I. Make Permanent Certain Tax Cuts Enacted in 2009														
1. Extension of American opportunity tax credit [2]	tyba 12/31/17	---	---	---	---	---	-2,364	-11,743	-11,397	-11,170	-10,854	-10,394	-2,364	-57,922
2. Reduce the earnings threshold for the refundable portion of the child tax credit to $3,000 [2]	tyba 12/31/17	---	---	---	---	---	---	-12,233	-12,383	-12,524	-12,686	-12,830	---	-62,656
3. Extend the earned income tax credit ("EITC") for larger families [2]	tyba 12/31/17	---	---	---	---	---	-22	-2,158	-2,192	-2,213	-2,276	-2,322	-22	-11,183
4. EITC modification and simplification - increase in joint returns beginning and ending income level for phaseout by $5,000 indexed after 2008 [2]	tyba 12/31/17	---	---	---	---	---	-17	-1,658	-1,702	-1,724	-1,756	-1,790	-17	-8,647
Total of Make Permanent Certain Tax Cuts Enacted in 2009		---	---	---	---	---	**-2,402**	**-27,793**	**-27,674**	**-27,631**	**-27,573**	**-27,335**	**-2,402**	**-140,408**
II. Incentives for Manufacturing, Research, Clean Energy, and Insourcing and Creating Jobs														
A. Provide Tax Incentives for Locating Jobs and Business Activity in the United States and Remove Tax Deductions for Shipping Jobs Overseas	epoia DOE	-1	-10	-10	-10	-11	-11	-12	-12	-13	-14	-14	-54	-119
B. Provide New Manufacturing Communities Tax Credit	DOE	---	-9	-46	-160	-325	-491	-605	-676	-716	-700	-570	-1,031	-4,298
C. Enhance and Make Permanent the R&E Tax Credit	tyba 12/31/12	-342	-4,671	-7,734	-9,025	-10,297	-11,487	-12,621	-13,752	-14,903	-16,082	-17,278	-43,556	-118,192
D. Extend Certain Employment Tax Credits Including Incentives for Hiring Veterans														
1. Permanently extend the work opportunity tax credit ("WOTC")	wptqiwbwftea 12/31/13	---	-368	-933	-1,197	-1,354	-1,479	-1,591	-1,689	-1,789	-1,895	-1,921	-5,331	-14,215
2. Permanently extend and modify the Indian employment credit	wptqei tyba 12/31/13	---	-7	-23	-32	-33	-34	-34	-34	-34	-34	-34	-129	-298
E. Provide a Tax Credit for the Production of Advanced Technology Vehicles	vpisa 12/31/13 & before 1/1/21	---	-6	-49	-148	-227	-320	-480	-410	-120	5	15	-750	-1,740
F. Provide a Tax Credit for Medium- and Heavy-Duty Alternative-Fuel Commercial Vehicles	vpisa 12/31/13 & before 1/1/20	---	-63	-102	-113	-138	-165	-188	-104	-56	-50	-35	-581	-1,014
G. Modify and Permanently Extend Renewable Electricity Production Tax Credit [2]	powcba 12/31/13	---	-132	-477	-909	-1,393	-2,007	-2,642	-3,337	-3,964	-4,623	-5,229	-4,919	-24,713

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
H. Modify and Permanently Extend the Deduction for Energy-Efficient Commercial Building Property	ppisa 12/31/13	---	-158	-273	-409	-498	-523	-536	-550	-545	-527	-529	-1,862	-4,549
Total of Incentives for Manufacturing, Research, Clean Energy, and Insourcing and Creating Jobs		**-343**	**-5,424**	**-9,647**	**-12,003**	**-14,276**	**-16,517**	**-18,709**	**-20,564**	**-22,140**	**-23,920**	**-25,595**	**-58,213**	**-169,138**
III. Tax Relief for Small Business														
A. Extend Increased Expensing for Small Business	qppisi tyba 12/31/13	---	-7,371	-13,108	-10,723	-9,306	-7,568	-5,606	-4,396	-3,988	-3,508	-3,916	-48,076	-69,490
B. Eliminate Capital Gains Taxation on Investments in Small Business Stock	qsbsaa 12/31/13	1	9	15	22	29	-114	-1,011	-1,313	-1,571	-1,696	-1,784	-38	-7,413
C. Double the Amount of Expensed Start-Up Expenditures	tyeo/a DOE	-9	-22	-29	-37	-46	-55	-65	-74	-85	-95	-107	-199	-625
D. Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance [2]	tyba 12/31/12	-46	-165	-310	-273	-204	-259	-251	-268	-315	-329	-350	-1,257	-2,771
Total of Tax Relief for Small Business		**-54**	**-7,549**	**-13,432**	**-11,011**	**-9,527**	**-7,996**	**-6,933**	**-6,051**	**-5,959**	**-5,628**	**-6,157**	**-49,570**	**-80,299**
IV. Incentives To Promote Regional Growth														
A. Extend and Modify the New Markets Tax Credit	DOE	---	-21	-83	-258	-370	-529	-702	-894	-1,102	-1,311	-1,486	-1,261	-6,757
B. Restructure Assistance to New York City, Provide Tax Incentives for Transportation Infrastructure [2]	tyba 12/31/13	---	-200	-200	-200	-200	-200	-200	-200	-200	-200	-200	-1,000	-2,000
C. Modify Tax-Exempt Bonds for Indian Tribal Governments	DOE	[3]	-3	-7	-11	-16	-22	-28	-35	-42	-49	-57	-59	-270
D. Reform and Expand the Low-Income Housing Tax Credit ("LIHTC")														
1. Allow states to convert private activity bond ("PAB") volume cap into LIHTCs that the State can allocate	[4]	---	[3]	-14	-47	-91	-128	-147	-150	-169	-202	-240	-280	-1,188
2. Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income	[5]	---	[3]	-3	-5	-8	-11	-14	-17	-20	-23	-26	-27	-127
3. Change formulas for 70 percent PV and 30 percent PV LIHTCs	ama 12/31/13	---	-1	-2	-5	-6	-6	-6	-6	-6	-6	-6	-20	-50
4. Add preservation of Federally assisted affordable housing to allocation criteria	ami cyba DOE	*Negligible Revenue Effect*												
5. Make the LIHTC beneficial to Real Estate Investment Trusts ("REITs")	[6]	---	[3]	-5	-10	-15	-21	-26	-32	-37	-43	-49	-51	-238
Total of Incentives To Promote Regional Growth		**[3]**	**-225**	**-314**	**-536**	**-706**	**-917**	**-1,123**	**-1,334**	**-1,576**	**-1,834**	**-2,064**	**-2,698**	**-10,630**
V. Reform U.S. International Tax System														
A. Defer Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries	tyba 12/31/13	---	2,621	6,207	7,183	7,360	7,033	6,357	6,001	4,224	2,413	2,581	30,403	51,978

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
B. Determine the Foreign Tax Credit on a Pooling Basis...	tyba 12/31/13	---	945	2,383	3,281	4,388	4,874	4,252	4,076	5,304	6,781	7,630	15,872	43,915
C. Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore.....	ti tyba 12/31/13	---	782	2,005	2,119	2,217	2,286	2,332	2,409	2,450	2,469	2,495	9,408	21,563
D. Limit Shifting of Income through Intangible Property Transfers.....	tyba 12/31/13	---	54	113	125	140	159	180	203	229	259	292	591	1,754
E. Disallow the Deduction for Non-Taxed Reinsurance Premiums Paid to Foreign Affiliates.....	pii tyba 12/31/13	---	397	966	1,046	1,134	1,229	1,331	1,442	1,562	1,692	1,833	4,772	12,633
F. Limit Earnings Stripping by Expatriated Entities.....	tyba 12/31/13	---	107	238	250	262	275	289	303	319	335	352	1,132	2,730
G. Modify Tax Rules for Dual Capacity Taxpayers.....	generally tyba 12/31/13	---	343	713	742	771	802	834	868	904	940	977	3,372	7,896
H. Tax Gain from the Sale of a Partnership Interest on Look-Through Basis.....	soea 12/31/13	---	146	218	232	246	259	271	282	295	307	320	1,101	2,576
I. Prevent Use of Leveraged Distributions from Related Foreign Corporations to Avoid Dividend Treatment.....	dma 12/31/13	---	182	270	288	306	322	337	352	367	383	399	1,367	3,205
J. Extend Section 338(h)(16) to Certain Asset Acquisitions.....	caaoa 12/31/13	---	60	100	100	100	100	100	100	100	100	100	460	960
K. Remove Foreign Taxes from a Section 902 Corporation's Foreign Tax Pool When Earnings are Eliminated.....	toa 12/31/13	---	11	23	25	28	32	36	41	46	52	58	118	351
Total of Reform U.S. International Tax System.....		---	**5,648**	**13,236**	**15,391**	**16,952**	**17,371**	**16,319**	**16,077**	**15,800**	**15,731**	**17,037**	**68,596**	**149,561**
VI. Reform Treatment of Financial and Insurance Industry Institutions and Products														
A. Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary.....	dceia 12/31/13	---	249	1,739	2,385	3,454	2,822	2,065	1,594	1,160	692	240	10,648	16,399
B. Modify Rules that Apply to Sales of Life Insurance Contracts.....	[7]	---	19	39	50	62	75	89	104	121	139	159	245	857
C. Modify Proration Rules for Life Insurance Company General and Separate Accounts.....	tyba 12/31/13	---	223	453	467	481	496	511	526	542	558	575	2,120	4,832
D. Extend Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance.....	[8]	---	76	254	379	507	633	754	872	985	1,097	1,208	1,849	6,765
Total of Reform Treatment of Financial and Insurance Industry Institutions and Products.....		---	**567**	**2,485**	**3,281**	**4,504**	**4,026**	**3,419**	**3,096**	**2,808**	**2,486**	**2,182**	**14,862**	**28,853**
VII. Eliminate Fossil Fuel Preferences														
A. Eliminate Oil And Gas Preferences														
1. Repeal enhanced oil recovery ("EOR") credit.....	tyba 12/31/13	*No Revenue Effect*												
2. Repeal credit for oil and gas produced from marginal wells.....	tyba 12/31/13	*No Revenue Effect*												
3. Repeal expensing of intangible drilling costs.....	cpoia 12/31/13	---	1,924	2,763	2,465	2,171	1,891	1,440	709	167	63	104	11,214	13,698

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
4. Repeal deduction for tertiary injectants	apoia 12/31/13	---	6	7	9	9	9	9	10	10	10	10	40	89
5. Repeal exception to passive loss limitations for working interests in oil and natural gas properties	tyba 12/31/13	---	9	19	19	19	19	19	19	19	19	20	85	181
6. Repeal percentage depletion for oil and natural gas wells	tyba 12/31/13	---	727	1,115	1,127	1,119	1,108	1,125	1,163	1,194	1,214	1,226	5,196	11,118
7. Repeal domestic manufacturing deduction for oil and natural gas production	tyba 12/31/13	---	703	1,812	1,953	2,069	2,104	2,099	2,108	2,139	2,181	2,224	8,642	19,392
8. Increase geological and geophysical amortization period for independent producers to seven years	apoia 12/31/13	---	165	278	255	203	153	103	53	19	11	11	1,054	1,251
B. Eliminate Coal Preferences														
1. Repeal expensing of exploration and development costs	cpoia 12/31/13	---	36	56	58	61	64	66	65	64	63	60	273	591
2. Repeal percentage depletion for hard mineral fossil fuels	tyba 12/31/13	---	35	55	57	59	60	62	64	65	68	71	266	595
3. Repeal capital gains treatment for royalties	ari tyba 12/31/13	2	26	37	59	62	64	67	70	73	76	67	250	603
4. Repeal domestic manufacturing deduction for the production of coal and other hard mineral fossil fuels	tyba 12/31/13	---	18	46	49	52	53	53	53	54	55	56	218	489
Total of Eliminate Fossil Fuel Preferences		**2**	**3,649**	**6,188**	**6,051**	**5,824**	**5,525**	**5,043**	**4,314**	**3,804**	**3,760**	**3,849**	**27,238**	**48,007**
VIII. Other Revenue Changes and Loophole Closers														
A. Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives	aspioiiUSa 12/31/13	---	84	112	112	112	113	113	113	114	114	115	533	1,103
B. Repeal Last-In, First-Out ("LIFO") Method of Accounting for Inventories	ftyba 12/31/13	---	4,059	8,132	8,160	8,188	8,217	8,247	8,277	8,308	8,339	8,371	36,758	78,299
C. Repeal Lower-Of- Cost-or-Market ("LCM") Inventory Accounting Method	tyba 12/31/13	---	541	1,082	1,084	1,086	587	89	91	93	95	97	4,380	4,845
D. Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft	ppisa 12/31/13	---	71	247	406	483	570	619	509	343	251	205	1,776	3,703
E. Repeal Gain Limitation for Dividends Received in Reorganization Exchanges	tyba 12/31/13	---	15	65	65	65	70	70	70	75	75	75	280	645
F. Expand the Definition of Built-In Loss for Purposes of Partnership Loss Transfers	soea DOE	2	38	45	49	53	55	58	62	64	68	71	242	565
G. Extend Partnership Basis Limitation Rules to Nondeductible Expenditures	ptybo/a DOE	4	85	103	110	118	125	132	140	147	154	162	545	1,280
H. Limit the Importation of Losses Under Related Party Loss Limitation Rules	tma DOE	6	83	89	95	102	108	114	120	126	133	139	483	1,115
I. Deny Deduction for Punitive Damages	dpoia 12/31/14	---	---	26	36	37	38	39	40	42	43	44	137	345
J. Eliminate Section 404(k) ESOP Dividend Deduction for Large C Corporations	dadpa DOE	86	464	681	705	730	755	782	809	837	867	897	3,421	7,613
Total of Other Revenue Changes and Loophole Closers		**98**	**5,440**	**10,583**	**10,822**	**10,974**	**10,639**	**10,263**	**10,231**	**10,148**	**10,138**	**10,175**	**48,555**	**99,513**

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
IX. Tax Relief to Create Jobs and Jumpstart Growth														
A. Provide Small Businesses a Temporary 10-Percent Tax Credit for New Jobs and Wage Increases [2]	qwpdt12mpbo DOE	---	-7,907	-11,716	-1,872	-807	-471	-202	---	---	---	---	-22,773	-22,975
B. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualified Advanced Energy Manufacturing Project	DOE	-156	-609	-555	-269	-123	-63	17	61	49	20	3	-1,775	-1,625
C. Designate Promise Zones														
1. Employment credit provided to businesses that employ zone residents	tyba 12/31/13	---	---	-49	-190	-332	-472	-560	-564	-567	-569	-565	-1,043	-3,867
2. Allow qualified property placed in service within the zone to be eligible for additional first-year depreciation of 100% of the adjusted basis of the property	tyba 12/31/13	---	---	-56	-211	-348	-438	-414	-289	-214	-168	-144	-1,053	-2,283
Total of Tax Relief to Create Jobs and Jumpstart Growth		**-156**	**-8,516**	**-12,376**	**-2,542**	**-1,610**	**-1,444**	**-1,159**	**-792**	**-732**	**-717**	**-706**	**-26,644**	**-30,750**
X. Incentives for Investment in Infrastructure														
A. Provide America Fast Forward Bonds and Expand Eligible Uses [2]	bio/a 1/1/4	---	-4	-36	-97	-182	-291	-408	-529	-651	-774	-899	-610	-3,871
B. Increase the Federal Subsidy Rate for America Fast Forward Bonds for School Construction [2]	bii 2014 and 2015	---	-64	-548	-1,403	-1,768	-1,590	-1,484	-1,416	-1,366	-1,320	-1,237	-5,373	-12,196
C. Allow Current Refundings of State and Local Governmental Bonds	DOE	*Negligible Revenue Effect*												
D. Repeal the $150 Million Nonhospital Bond Limitation on all Qualified 501(C)(3) Bonds	bia DOE	---	[3]	-1	-3	-6	-8	-11	-13	-16	-19	-22	-18	-99
E. Increase National Limitation Amount for Qualified Highway or Surface Freight Transfer Facility Bonds	DOE	---	[3]	[3]	-2	-11	-24	-37	-48	-52	-52	-52	-37	-278
F. Eliminate the Volume Cap for Private Activity Bonds for Water Infrastructure	bia DOE	---	[3]	[3]	-2	-4	-8	-13	-19	-25	-32	-39	-14	-142
G. Increase the 25-Percent Limit on Land Acquisition Restriction on Private Activity Bonds	bia DOE	---	[3]	-3	-7	-13	-20	-27	-35	-42	-50	-58	-43	-255
H. Allow More Flexible Research Arrangements for Purposes of Private Business Use Limits	raeia DOE	---	[3]	-1	-3	-5	-8	-10	-13	-16	-18	-21	-17	-95
I. Repeal the Government Ownership Requirement for Certain Types of Exempt Facility Bonds	bia DOE	-2	-22	-91	-185	-260	-324	-393	-463	-534	-605	-677	-884	-3,556
J. Exempt Certain Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act ("FIRPTA")	doUSrpioa 12/31/13	---	-122	-182	-194	-206	-216	-226	-236	-246	-256	-267	-919	-2,150
Total of Incentives for Investment in Infrastructure		**-2**	**-212**	**-862**	**-1,896**	**-2,455**	**-2,489**	**-2,609**	**-2,772**	**-2,948**	**-3,126**	**-3,272**	**-7,915**	**-22,642**

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
XI. Tax Cuts for Families and Individuals														
A. Provide for Automatic Enrollment in Individual Retirement Accounts ("IRAs") or Annuities, Including a Small Employer Tax Credit, and Double the Tax Credit for Small Employer Plan Start-Up Costs [2]	tyba 12/31/14	---	---	-254	-1,033	-1,117	-1,200	-1,256	-1,320	-1,385	-1,461	-1,546	-3,605	-10,573
B. Expand the Child and Dependent Care Tax Credit [2]	tyba 12/31/13	---	-9	-948	-927	-929	-913	-896	-879	-860	-835	-816	-3,726	-8,011
C. Extend Exclusion from Income for Cancellation of Certain Home Mortgage Debt (sunset 12/31/15)	doioa 12/31/13	---	-558	-3,556	-2,225	---	---	---	---	---	---	---	-6,339	-6,339
D. Provide Exclusion from Income for Student Loan Forgiveness for Students in Certain Income-Based or Income-Contingent Repayment Programs Who Have Completed Payment Obligations	lfa 12/31/13	---	---	---	---	---	---	---	-1	-1	-1	-2	---	-5
E. Provide Exclusion from Income for Student Loan Forgiveness and for Certain Scholarship Amounts for Participants in the Indian Health Service Health Professions Programs [9]	tyba 12/31/13	---	-3	-13	-13	-14	-14	-14	-14	-14	-14	-14	-58	-129
Total of Tax Cuts for Families and Individuals		---	**-570**	**-4,771**	**-4,198**	**-2,060**	**-2,127**	**-2,166**	**-2,214**	**-2,260**	**-2,311**	**-2,378**	**-13,728**	**-25,057**
XII. Upper-Income Tax Provisions														
A. Reduce the Value of Certain Tax Expenditures	tyba 12/31/13	-2,698	14,015	42,036	41,725	45,746	49,709	53,085	56,319	59,844	63,486	66,891	190,533	490,158
B. Implement the Buffet Rule by Imposing a New "Fair Share Tax" [10]	tyba 12/31/13	1,123	13,390	-733	6,638	6,352	6,367	6,792	7,145	7,407	7,808	8,165	33,137	70,454
Total of Upper-Income Tax Provisions		**-1,575**	**27,405**	**41,303**	**48,363**	**52,098**	**56,076**	**59,877**	**63,464**	**67,251**	**71,294**	**75,056**	**223,670**	**560,612**
XIII. Modify Estate and Gift Tax Provisions														
A. Restore the Estate, Gift and Generation-Skipping Transfer ("GST") Tax Parameters in Effect in 2009 with Portability of Exemption Amount Between Spouses	dda & tma 12/31/17	---	---	---	31	246	3,277	8,569	10,312	12,956	15,968	17,320	3,554	68,679
B. Require Consistency in Value for Transfer and Income Tax Purposes	to/a DOE	---	63	125	133	139	148	167	180	190	198	205	609	1,551
C. Require a Minimum Term for Grantor Retained Annuity Trusts ("GRATs")	tca DOE	---	---	---	10	47	112	241	392	595	856	1,132	169	3,384
D. Limit Duration of GST Tax Exemption	tca DOE	*Negligible Revenue Effect*												
E. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts	tco/a DOE	---	1	8	27	65	132	257	395	573	783	986	233	3,227
F. Extend the Lien on Estate Tax Deferrals Provided Under Section 6166 of the Internal Revenue Code (the "Code")	[11]	[12]	2	4	6	7	9	9	8	8	7	7	28	68

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
G. Clarify GST Tax Treatment of Health and Education Exclusion Trusts ("HEETs")	[13]	---	-10	-18	-18	-17	-15	-15	-14	-12	-11	-10	-79	-141
Total of Modify Estate and Gift Tax Provisions		**[12]**	**56**	**119**	**189**	**487**	**3,663**	**9,228**	**11,273**	**14,310**	**17,801**	**19,640**	**4,514**	**76,768**
XIV. Reform Treatment of Financial and Insurance Industry Institutions and Products														
A. Impose a Financial Crisis Responsibility Fee	1/1/15	---	---	2,492	5,055	5,267	5,484	5,699	5,966	6,225	6,495	6,773	18,298	49,456
B. Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt	dsaa 12/31/13	---	11	44	92	142	177	183	164	133	97	64	467	1,107
C. Require that the Cost Basis of Stock that is a Covered Security Must Be Determined Using an Average Cost Basis Method	psao/a 1/1/14	-2	-10	-7	17	71	115	148	189	235	274	315	186	1,347
Total of Reform Treatment of Financial and Insurance Industry Institutions and Products		**-2**	**1**	**2,529**	**5,164**	**5,480**	**5,776**	**6,030**	**6,319**	**6,593**	**6,866**	**7,152**	**18,951**	**51,910**
XV. Other Revenue Changes and Loophole Closers														
A. Levy a Fee on the Production of Hardrock Minerals to Restore Abandoned Mines [14]	10/1/13	---	---	151	150	150	149	149	149	149	149	148	601	1,345
B. Return Fees on the Production of Coal to Pre-2006 Levels to Restore Abandoned Mines (sunset 9/30/21) [14]	10/1/13	---	40	39	40	40	40	40	41	41	---	---	198	320
C. Increase Oil Spill Liability Trust Fund Financing Rate by One Cent and Update the Law to Include Other Sources of Crudes [15]	[16]	---	90	143	152	170	185	197	210	226	240	251	739	1,863
D. Reinstate and Extend Superfund Excise Taxes	pa 12/31/13 & before 1/1/24	---	579	796	809	822	831	841	852	864	875	883	3,838	8,153
E. Reinstate Superfund Environmental Income Tax	tyba 12/31/13 & before 1/1/24	---	765	1,248	1,283	1,310	1,333	1,356	1,392	1,401	1,415	1,421	5,938	12,923
F. Increase Tobacco Taxes and Index for Inflation [2] [17]	ara 12/31/13	---	6,744	8,003	7,916	8,140	8,381	8,634	8,881	9,120	9,334	9,540	39,184	84,693
G. Make the 0.2 Percent Unemployment Insurance Surtax Permanent [14]	1/1/14	---	1,030	1,396	1,427	1,456	1,476	1,491	1,505	1,519	1,533	1,544	6,785	14,377
H. Provide Short-Term Tax Relief to Employers and Expand Federal Unemployment Tax Act ("FUTA") Base [2] [14]	8/1/13	-623	-4,411	-4,229	4,555	9,775	4,116	-1,241	-2,618	817	1,831	3,776	9,183	11,748
I. Tax Carried (Profits) Interests as Ordinary Income	tyea 12/31/13	361	1,599	762	1,795	2,244	2,209	1,963	1,845	1,672	1,542	1,409	8,970	17,401
J. Eliminate the Deduction for Contributions of Conservation Easements on Golf Courses	DOE	---	15	24	24	24	25	25	26	26	27	28	110	242
K. Restrict Deductions and Harmonize the Rules for Contributions of Conservation Easements for Historic Preservation	cma DOE	---	11	26	27	28	29	29	30	31	32	33	121	277

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
L. Require Non-Spouse Beneficiaries of IRA or Annuity Owners and Retirement Plan Participants to Take Inherited Distributions Over No More Than Five Years	[18]	---	[12]	35	133	244	409	789	824	782	737	689	821	4,642
M. Limit the Total Accrual of Tax-Favored Retirement Benefits	caaf tybo/a 1/1/14	---	76	152	210	282	330	360	462	541	639	832	1,050	3,884
Total of Other Revenue Changes and Loophole Closers		**-262**	**6,538**	**8,547**	**18,521**	**24,684**	**19,512**	**14,633**	**13,599**	**17,189**	**18,354**	**20,555**	**77,538**	**161,868**
XVI. Reduce the Tax Gap and Make Reforms														
A. Expand Information Reporting														
1. Require information reporting for private separate accounts of life insurance companies	tyba 12/31/13	*Negligible Revenue Effect*												
2. Require a certified taxpayer identification number ("TIN") from contractors and allow certain withholding	pmtca 12/31/13	---	6	46	33	36	38	41	43	45	48	51	159	387
3. Modify reporting of tuition expenses and scholarships on Form 1098-T [2]	tyba 12/31/13	---	4	41	43	45	48	51	54	57	60	64	181	466
4. Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act ("FATCA")	DOE	*No Revenue Effect*												
B. Improve Compliance By Businesses														
1. Require greater electronic filing of returns	tyea 12/31/13	*No Revenue Effect*												
2. Make e-filing mandatory for exempt organizations	generally tyba DOE	*No Revenue Effect*												
3. 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	pyba 12/31/13	*Negligible Revenue Effect*												
4. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes	[19]	*Negligible Revenue Effect*												
5. Increase certainty with respect to worker classification [20]	generally DOE	8	334	553	755	897	954	982	1,005	1,034	1,070	1,104	3,502	8,698
6. Repeal special estimated tax payment provision for certain insurance companies	tyba 12/31/13	*Negligible Revenue Effect*												
C. Strengthen Tax Administration														
1. Impose liability on shareholders participating in "Intermediary Transaction Tax Shelters" to collect unpaid corporate income taxes	DOE	[12]	88	123	130	138	145	152	159	166	173	180	625	1,453
2. Increase levy authority for payments to Medicare providers with delinquent tax debt	pma DOE	---	56	76	78	80	81	83	84	86	88	90	371	802

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
3. Implement a program integrity statutory cap adjustment for tax administration [14] [21]	10/1/13	---	458	1,254	2,448	3,547	4,545	5,143	5,425	5,434	5,356	5,227	12,252	38,837
4. Enhance unemployment insurance program integrity [2] [22]	DOE	---	21	25	14	6	1	-1	-1	1	3	4	67	73
5. Streamline audit and adjustment procedures for large partnerships	[23]	---	39	157	197	198	199	197	192	195	201	207	790	1,782
6. Revise offer-in-compromise application rules	oicsa DOE	-3	-3	[24]	[24]	[24]	[24]	[24]	[24]	[24]	[24]	[24]	-6	-6
7. Expand Internal Revenue Service ("IRS") access to information in the National Directory of New Hires for tax administration purposes	DOE	*No Revenue Effect*												
8. Make repeated willful failure to file a tax return a felony	rrtbfa 12/31/13	*Negligible Revenue Effect*												
9. Facilitate tax compliance with local jurisdictions	Dma DOE	*Negligible Revenue Effect*												
10. Extend statute of limitations where State adjustment affects Federal tax liability	rrtbfa 12/31/13	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	1	2
11. Improve investigative disclosure statute	Dma DOE	*Negligible Revenue Effect*												
12. Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a 2-D bar code	trfa 12/31/13	*No Revenue Effect*												
13. Allow the IRS to absorb credit and debit card processing fees for certain tax payments	pma DOE	*Negligible Revenue Effect*												
14. Provide the Secretary of Treasury authority to access and use prisoner data maintained by SSA, in order to identify improper payments [2]	DOE	---	12	24	25	25	26	27	28	28	29	30	111	254
15. Extend IRS math error authority in certain circumstances [2]	tyba 12/31/13	---	[12]	12	13	13	14	14	14	15	15	16	52	126
16. Impose a penalty on failure to comply with electronic filing requirements	rrtbfea 12/31/13	*Negligible Revenue Effect*												
17. Restrict access to the Death Master File ("DMF") [2]	DOE	---	53	73	75	77	80	82	84	87	90	92	358	793
18. Provide whistleblowers with protection from retaliation	DOE	*Negligible Revenue Effect*												
19. Provide stronger protection from improper disclosure of taxpayer information in whistleblower actions	DOE	*No Revenue Effect*												
20. Index all penalties to inflation	DOE	---	1	2	4	6	8	11	14	17	20	23	21	107
21. Extend paid preparer earned income tax credit ("EITC") due diligence requirements to the child tax credit ("CTC") [2]	tyba 12/31/13	---	---	6	5	5	5	5	5	5	5	5	20	44
22. Extend IRS authority to require truncated Social Security Numbers on Form W–2	DOE	*Negligible Revenue Effect*												
23. Add tax crimes to the Aggravated Identity Theft Statute	DOE	*Negligible Revenue Effect*												

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
24. Impose a civil penalty on tax identity theft crimes	DOE	*Negligible Revenue Effect*												
Total of Reduce the Tax Gap and Make Reforms		**5**	**1,068**	**2,392**	**3,820**	**5,074**	**6,144**	**6,786**	**7,106**	**7,170**	**7,158**	**7,092**	**18,505**	**53,818**
XVII. Simplify the Tax System														
A. Simplify the Rules for Claiming the EITC for Workers Without Qualifying Children [2]	tyba 12/31/13	---	-1	-113	-115	-116	-121	-124	-127	-131	-134	-136	-466	-1,118
B. Modify Adoption Credit to Allow Tribal Determination of Special Needs	tyba 12/31/13	---	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-2	-6
C. Eliminate Minimum Required Distribution ("MRD") Requirements for IRA/Plan Balances of $75,000 or Less	[25]	---	-5	-25	-39	-45	-45	-49	-51	-53	-54	-56	-159	-421
D. Allow All Inherited Plan and IRA Accounts to be Rolled Over Within 60 Days	dma 12/31/13	*Negligible Revenue Effect*												
E. Repeal Non-Qualified Preferred Stock ("NQPS") Designation	sia 12/31/13	---	5	11	11	12	12	13	13	13	13	13	51	116
F. Repeal Preferential Dividend Rule for Publicly Offered REITs	dmi tyba DOE	*Negligible Revenue Effect*												
G. Reform Excise Tax Based on Investment Income of Private Foundations	tyba DOE	---	-7	-10	-11	-12	-12	-12	-12	-12	-12	-12	-52	-112
H. Remove Bonding Requirements for Certain Taxpayers Subject to Federal Excise Taxes on Distilled Spirits, Wine, and Beer	90da DOE	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]
I. Simplify Arbitrage Investment Restrictions	bia DOE	-5	-33	-50	-58	-67	-74	-78	-81	-82	-84	-86	-287	-698
J. Simplify Single-Family Housing Mortgage Bond Targeting Requirements	bia DOE	---	-5	-14	-29	-50	-75	-102	-130	-158	-186	-215	-173	-964
K. Streamline Private Business Limits on Governmental Bonds	bia DOE	---	-1	-3	-4	-6	-8	-11	-13	-15	-18	-20	-22	-99
L. Exclude Self-Constructed Assets of Small Taxpayers from the Uniform Capitalization ("UNICAP") Rules	cii tyba 12/31/13	---	-40	-81	-83	-85	-86	-88	-90	-92	-94	-95	-376	-835
M. Repeal Technical Terminations of Partnerships	to/a 12/31/13	---	7	13	15	17	18	19	20	21	22	23	70	175
N. Repeal Anti-Churning Rules of Code Section 197	aa 12/31/13	---	-27	-95	-203	-338	-473	-541	-541	-541	-541	-541	-1,136	-3,841
Total of Simplify the Tax System		**-5**	**-107**	**-368**	**-517**	**-691**	**-864**	**-973**	**-1,013**	**-1,051**	**-1,089**	**-1,127**	**-2,552**	**-7,803**
XVIII. User Fees														
A. Reform Inland Waterways Funding [14]	10/1/13	---	62	85	85	85	84	84	84	84	84	85	401	823
B. Increase fees for Migratory Bird Hunting and Conservation Stamps [14]	10/1/13	---	5	12	12	12	12	12	12	12	12	12	55	117
C. Establish a Mandatory Surcharge for Air Traffic Services	fba 9/30/13	---	652	784	803	814	826	838	851	864	877	891	3,879	8,199
D. Reauthorize Special Assessment On Domestic Nuclear Utilities [14]	10/1/13	---	151	154	157	159	163	166	170	174	177	181	784	1,653
Total of User Fees		**---**	**871**	**1,036**	**1,057**	**1,071**	**1,086**	**1,101**	**1,118**	**1,134**	**1,151**	**1,169**	**5,120**	**10,791**

Provision	Effective	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
XIX. Trade Initiative - Extend the Generalized System of Preferences (sunset 9/30/15) [14]	**8/1/13**	**-62**	**-384**	**-417**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-863**	**-863**
XX. Other Initiatives														
A. Increase Employee Contributions to Federal Defined Benefit Retirement Plans [14]	10/1/13	---	779	1,537	2,273	2,254	2,244	2,229	2,208	2,185	2,155	2,119	9,087	19,983
B. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents	DOE	*Negligible Revenue Effect*												
C. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of the Economy	DOE	*No Revenue Effect*												
D. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration ("TIGTA")	tyba 12/31/13	*No Revenue Effect*												
E. Modify Indexing to Prevent Deflationary Adjustments	DOE	*No Revenue Effect*												
F. Replace the Consumer Price Index ("CPI") with the Chained CPI for Purposes of Indexing Tax Provisions for Inflation [2] [26]	tyba 12/31/14	---	---	1,003	3,006	6,344	8,869	11,350	15,680	19,672	22,987	26,794	19,222	115,704
Total of Other Initiatives		**---**	**---**	**2,540**	**5,279**	**8,598**	**11,113**	**13,579**	**17,888**	**21,857**	**25,142**	**28,913**	**28,309**	**135,687**
NET TOTAL		**-2,356**	**29,035**	**48,771**	**85,236**	**104,421**	**106,175**	**84,813**	**92,071**	**103,768**	**113,682**	**124,186**	**371,272**	**889,797**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is generally assumed to be July 1, 2013.

[Legend and Footnotes for JCX-11-13 appear on the following pages]

Legend for JCX-11-13:

Legend for "Effective" column:

aa = acquisitions after
ama = allocations made after
ami = allocations made in
apoia = amounts paid or incurred after
ara = articles removed after
ari = amounts realized in
aspioiiUSa = all spirits produced in or imported into the United States after
bii = bonds issued in
bio/a = bonds issued on or after
caaf = contributions and accruals for
caaoa = covered asset acquisitions occurring after
cii = costs incurred in
cma = contributions made after
cpoia = costs paid or incurred after
cyba = calendar years beginning after
dadpa = dividends and distributions paid after
dceia = derivative contracts entered into after
dda = decedents dying after
Dma = disclosures made after
dma = distributions made after
dmi = distributions made in
DOE = date of enactment
doioa = discharge of indebtedness occurring after
doUSrpioa = dispositions of U.S. real property interests occurring after
dpoia = damages paid or incurred after
dsaa = debt securities acquired after
epoia = expenses paid or incurred after
fba = flights beginning after
ftyba = first taxable year beginning after
lfa = loans forgiven after
oicsa = offers-in-compromise submitted after
pa = periods after
pii = policies issued in
pma = payments made after
pmtca = payments made to contractors after
powcba = property on which construction begins after
ppisa = property placed in service after
psao/a = portfolio stock acquired on or after
ptybo/a = partnership's taxable year beginning on or after
pyba = plan years beginning after
qppisi = qualifying property placed in service in
qsbsaa = qualified small business stock acquired after
qwpdt12mpbo = qualified wages paid during the 12-month period beginning on
raeia = research agreements entered into after
rrtbfa = returns required to be filed after
rrtbfea = returns required to be filed electronically after
sia = stock issued after
soea = sales or exchanges after
tca = trusts created after
tco/a = trusts created on or after
ti = transactions in
tma = transfers made after
toa = transactions occurring after
to/a = transfers on or after
trfa = tax returns filed after
tyba = taxable years beginning after
tybo/a = taxable years beginning on or after
tyea = taxable years ending after
tyeo/a = taxable years ending on or after
vpisa = vehicles placed in service after
wptqei = wages paid to qualified employees in
wptqiwbwftea = wages paid to qualified individuals who begin work for the employer after
90da = 90 days after

[Footnotes for JCX-11-13 appear on the following pages]

Footnotes for JCX-11-13:

[1] To the extent the proposals are not fully specified, estimates will be updated as new information becomes available and policy intent is clarified.

[2] Estimate includes the following outlay effects [27]:	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
American opportunity tax credit	---	---	---	---	---	---	5,471	5,338	5,248	5,176	5,038	---	26,271
Reduce the earnings threshold for the refundable portion of the child tax credit to $3,000	---	---	---	---	---	---	12,233	12,383	12,524	12,686	12,830	---	62,656
Extend EITC for larger families	---	---	---	---	---	21	2,065	2,099	2,128	2,184	2,225	21	10,722
EITC modification and simplification ($5,000)	---	---	---	---	---	15	1,461	1,495	1,508	1,532	1,563	15	7,574
Modify and permanently extend renewable electricity production tax credit	---	35	108	175	226	288	328	364	366	375	364	833	2,630
Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance	4	14	26	23	17	22	21	23	27	28	30	107	236
Restructure assistance to New York City, provide tax incentives for transportation infrastructure	---	200	200	200	200	200	200	200	200	200	200	1,000	2,000
Provide small businesses a temporary 10-percent tax credit for new jobs and wage increases	---	112	159	---	---	---	---	---	---	---	---	272	272
Provide America Fast Forward Bonds and expand eligible use	---	65	549	1,490	2,809	4,486	6,283	8,139	10,025	11,923	13,838	9,399	59,607
Increase the Federal subsidy rate for America Fast Forward Bonds for school construction	---	115	989	2,564	3,364	3,330	3,297	3,264	3,231	3,199	3,167	10,362	26,520
Provide for automatic enrollment in IRAs, including a small employer tax credit, and double the tax credit for small employer plan start-up costs	---	---	---	315	365	397	411	426	440	461	480	1,076	3,294
Expand child and dependent care tax credit	---	3	318	343	400	410	413	420	418	415	417	1,474	3,557
Increase tobacco taxes and index for inflation [14]	---	-10	-54	-98	-139	-179	-215	-250	-279	-301	-305	-480	-1,829
Provide short-term tax relief to employers and expand FUTA base [14]	623	387	---	---	---	---	---	---	---	---	---	1,010	1,010
Modify reporting of tuition expenses and scholarships on Form 1098-T	---	-1	-12	-13	-14	-14	-15	-16	-17	-18	-19	-54	-140
Enhance unemployment insurance program integrity	---	-21	-26	-20	-17	-15	-14	-13	-14	-15	-15	-99	-170
Provide the Secretary of Treasury authority to access and use prisoner data maintained by SSA, in order to identify improper payments	---	-4	-8	-8	-8	-9	-9	-9	-9	-10	-10	-37	-84
Extend IRS math error authority in certain circumstances	---	[28]	-3	-3	-3	-3	-3	-4	-4	-4	-4	-13	-31
Restrict access to the DMF	---	-18	-24	-25	-26	-27	-27	-28	-29	-30	-31	-119	-264
Extend paid preparer EITC due diligence requirements to the CTC	---	---	-5	-4	-4	-4	-4	-4	-4	-4	-4	-18	-40
Simplify the rules for claiming the EITC for workers without qualifying children	---	1	100	101	102	105	107	110	113	119	121	409	980
Use alternative CPI measure to index tax parameters	---	---	---	-284	-665	-1,286	-1,658	-2,024	-2,683	-3,196	-3,544	-2,235	-15,340
Chained CPI effects on health coverage provisions	---	---	---	---	---	---	-33	-87	-154	-238	-368	---	-880
Total Outlay Effects	627	878	2,317	4,755	6,607	7,737	30,313	31,827	33,035	34,483	35,972	22,923	188,551

[3] Loss of less than $500,000.

[4] 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.

[5] Effective for elections under section 42(g)(1) that are made after the date of enactment.

[6] Effective for taxable years of a REIT that end after the date of enactment.

[7] Effective for sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2013.

[Footnotes for JCX-11-13 are continued on the following page]

Footnotes for JCX-11-13 continued:

[8] Effective for contracts issued after December 31, 2013, in taxable years ending after that date.

[9] Estimate includes the following effects:

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
Total Revenue Effects	---	-3	-13	-13	-14	-14	-14	-14	-14	-14	-14	-58	-129
On-budget effects	---	-1	-8	-8	-8	-8	-9	-9	-9	-9	-9	-34	-78
Off-budget effects	---	-3	-5	-5	-5	-5	-5	-5	-5	-6	-6	-23	-51

[10] Estimate includes interaction with item XV.I. (Tax Carried (Profits) Interests as Ordinary Income).

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

[12] Gain of less than $500,000.

[13] Effective for trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.

[14] Estimate provided by the Congressional Budget Office.

[15] The revenue estimate assumes a permanent extension of the financing rate at the rate of 10 cents per barrel effective for production after December 31, 2017.

[16] Effective at the applicable rate on such crudes received at a U.S. refinery, entered into the United States, or used or exported as described above after December 31, 2013.

[17] Estimate provided in consultation with the Congressional Budget Office and includes both outlay effects (see footnote 2 above) and indirect effects (following) resulting from the health benefits of a reduction in tobacco consumption:

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
On-budget effects	---	8	23	32	39	46	56	67	80	94	122	148	568
Off-budget effects	---	3	9	12	15	18	22	26	31	36	46	59	218

[18] Effective for distributions with respect to plan participants or IRA owners who die after December 31, 2013.

[19] Effective for employment tax returns required to be filed with respect to wages paid after December 31, 2013.

[20] Estimate includes the following effects:

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
Total Revenue Effects	8	334	553	755	897	954	982	1,005	1,034	1,070	1,104	3,502	8,698
On-budget effects	-6	-21	-39	-50	-88	-124	-130	-135	-141	-147	-150	-328	-1,030
Off-budget effects	15	355	592	805	986	1,078	1,112	1,141	1,175	1,217	1,254	3,831	9,729

[21] The budgetary savings would not be counted for Congressional scorekeeping purposes.

[22] Estimate provided by the Joint Committee on Taxation in consultation with the Congressional Budget Office.

[23] Effective for a partnership's taxable year ending on or after the date that is two years from the date of enactment.

[24] Negligible revenue effect.

[25] 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.

[26] Estimate includes the following off-budget effects on health coverage provisions:

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2013-18	2013-23
	---	---	---	---	---	---	17	21	98	175	313	---	624

[27] The outlay effects are preliminary and subject to change.