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General Explanations  
of the  
Administration's Fiscal Year 2016  
Revenue Proposals

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Department of the Treasury  
February 2015



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## NOTES

The Administration's proposals are not intended to create any inferences regarding current law. Within the *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, unless otherwise stated:

- "Code" refers to the Internal Revenue Code
- "Section" refers to the respective section of the Internal Revenue Code
- "Secretary" refers to the Secretary of the Treasury
- "Budget" refers to the *Fiscal Year 2016 Budget of the U.S. Government*
- "IRS" refers to the Internal Revenue Service
- "TIN" refers to Taxpayer Identification Number
- "AGI" refers to Adjusted Gross Income
- "IRA" refers to Individual Retirement Account or Annuity



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

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The BBEDCA baseline, which is commonly used in budgeting and is defined in the statute, reflects, with some exceptions, the projected receipts level under current law. However, while the American Taxpayer Relief Act of 2012 (ATRA) made most of the 2001 and 2003 tax cuts and Alternative Minimum Tax relief permanent, it extended the American Opportunity Tax Credit (AOTC), Earned Income Tax Credit (EITC) expansions, and Child Tax Credit (CTC) expansions only through 2017. The Budget uses an adjusted baseline that permanently continues the AOTC and the EITC and CTC expansions extended through 2017 under ATRA.

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

### **Current Law**

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

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

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

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

### **Reasons for Change**

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

## **Proposal**

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

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

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

### **Current Law**

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

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

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

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

The end of the phase-in range and the beginning of the phase-out range are indexed for inflation. Hence, the maximum amount of the credit and the end of the phase-out range are effectively indexed. The following chart summarizes the EITC parameters for 2015.



## EITC Parameters for 2015

	Childless Taxpayers	Taxpayers with Qualifying Children		
		One Child	Two Children	Three or More
Phase-in rate	7.65%	34.00%	40.00%	45.00%
Minimum earnings for maximum credit	\$6,580	\$9,880	\$13,870	\$13,870
Maximum credit	\$503	\$3,359	\$5,548	\$6,242
Phase-out rate	7.65%	15.98%	21.06%	21.06%
Phase-out begins	\$8,240 (\$13,750 joint)	\$18,110 (\$23,630 joint)	\$18,110 (\$23,630 joint)	\$18,110 (\$23,630 joint)
Phase-out ends	\$14,820 (\$20,330 joint)	\$39,131 (\$44,651 joint)	\$44,454 (\$49,974 joint)	\$47,747 (\$53,267 joint)

To be eligible for the EITC, workers must have no more than \$3,400 of investment income. (This amount is indexed for inflation.)

### **Reasons for Change**

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

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

### **Proposal**

The adjusted baseline for the Budget makes permanent the expansion of the EITC enacted as part of ARRA and temporarily extended by ATRA.

#### **Permanently extend EITC marriage penalty relief**

The phase-out range for married couples would begin at income levels \$5,000 higher than those for unmarried filers (indexed for inflation after 2009).

#### **Permanently extend EITC for larger families**

The phase-in rate of the EITC for workers with three or more qualifying children would be maintained at 45 percent.

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

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

### **Current Law**

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

Prior to the ARRA, an individual taxpayer could claim a nonrefundable Hope Scholarship credit for 100 percent of the first \$1,300 and 50 percent of the next \$1,300 in qualified tuition and related expenses (for a maximum credit of \$1,950) per student. These amounts are indexed for inflation; the amounts that would have been in effect for 2015 are shown. The Hope Scholarship credit was available only for the first two years of postsecondary education. To qualify for either the AOTC or Hope credit, the student must be enrolled at least half-time.

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

In 2015, both the Hope credit and the Lifetime Learning Credit phase out between \$55,000 and \$65,000 of AGI (\$110,000 and \$130,000 if married filing jointly, indexed for inflation). In contrast, the AOTC is available to families with higher incomes.

Taxpayers may claim only one education benefit per student on their tax return.

### **Reasons for Change**

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

Under prior law, some low-income families (those without sufficient income tax liability) could not benefit from the Hope Scholarship credit or the Lifetime Learning Credit because they were not refundable. In 2014, the maximum available credit covered about 75 percent of tuition and fees at the average two-year public institution, or about 27 percent of tuition and fees for an in-state student attending the average four-year public institution.

Unlike the Hope Scholarship credit that applies for only the first two years of college, the AOTC is available for the first four years of college. This may increase the likelihood that students will stay in school and complete their degrees. More years of schooling translates into higher future incomes (on average) for students and a more educated workforce for the country.

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

**Proposal**

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

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

## **RESERVE FOR BUSINESS TAX REFORM THAT IS REVENUE NEUTRAL IN THE LONG RUN**

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The number of special deductions, credits, and other tax preferences provided to businesses in the Internal Revenue Code has expanded significantly since the last comprehensive tax reform effort nearly three decades ago. Such tax preferences help well-connected special interests, but do little for economic growth. To be successful in an increasingly competitive global economy, the Nation cannot afford to maintain a tax code burdened with such tax breaks; instead, the tax code needs to ensure that the United States is the most attractive place for entrepreneurship and business growth. Therefore, in the Budget, the President is calling on the Congress to immediately begin work on business tax reform that achieves the following five goals: (1) cut the corporate tax rate and pay for it by making structural reforms and eliminating loopholes and subsidies; (2) strengthen American manufacturing and innovation; (3) strengthen the international tax system; (4) simplify and cut taxes for small businesses; and (5) avoid adding to deficits in the short-term or the long-term.

Consistent with these goals, the Budget includes a detailed set of business proposals that close loopholes and provide incentives for growth in a fiscally responsible manner.

The Administration proposes that these policies be enacted as part of business tax reform that is revenue neutral over the long run. As a result, the net savings from these proposals, which are described below, are not reflected in the budget estimates of receipts and are generally not counted toward meeting the Administration's deficit reduction goals. However, as part of transitioning to a reformed international tax system, the President's plan would impose a one-time transition toll charge of 14 percent on the \$1 to \$2 trillion of untaxed foreign earnings that U.S. companies have accumulated overseas. The Budget proposes to use the one-time savings from this toll charge to pay for investment in transportation infrastructure.

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

### **RESTRICT DEDUCTIONS FOR EXCESSIVE INTEREST OF MEMBERS OF FINANCIAL REPORTING GROUPS**

#### **Current Law**

Business interest payments generally are deductible from taxable income while dividend payments are not deductible. An exception to this general rule is section 163(j), which denies U.S. tax deductions for excess interest paid by a corporation to a related party when (1) the corporation's debt-equity ratio exceeds 1.5, and (2) net interest expense, meaning interest expense less interest income, exceeds 50 percent of the corporation's adjusted taxable income (computed by adding back to taxable income net interest expense, depreciation, amortization, depletion, and any net operating loss deduction, and any deduction for domestic production activities under section 199). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In addition, the corporation's excess limitation for a tax year (i.e., the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

#### **Reasons for Change**

The fungibility of money makes it easy for multinational groups to substitute debt for equity in a controlled entity in order to shift profits to lower-tax jurisdictions. Although section 163(j) places a cap on the amount of interest expense a corporation can deduct relative to its U.S. earnings, section 163(j) does not consider the leverage of a multinational group's U.S. operations relative to the leverage of the group's worldwide operations. Therefore, under current law, multinational groups are able to inappropriately reduce their U.S. tax on income earned from U.S. operations by over-leveraging their U.S. operations relative to those located in lower-tax jurisdictions. The Administration has included a separate proposal to address this concern for U.S.-parented groups as part of the Budget, *Impose a 19-Percent Minimum Tax on Foreign Income*. Nonetheless, opportunities remain for foreign-parented multinationals to disproportionately leverage the operations of a U.S. subgroup.

#### **Proposal**

The proposal generally would apply to an entity that is a member of a group that prepares consolidated financial statements ("financial reporting group") in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or other method authorized by the Secretary under regulations. Under the proposal, a member's deduction for interest expense generally would be limited if the member has net interest expense for tax purposes and the member's net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member's proportionate share of the net interest expense reported on the financial reporting group's consolidated financial statements (excess financial statement net interest expense). A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense,

taxes, depreciation, and amortization) reflected in the group's financial statements. When a member has excess financial statement net interest expense, the member will have excess net interest expense for tax purposes for which a deduction is disallowed in the same proportion that the member's net interest expense for financial reporting purposes is excess financial statement net interest expense. Alternatively, if a member's net interest expense for financial reporting purposes is less than the member's proportionate share of the net interest expense reported on the group's consolidated financial statements, such excess limitation would be converted into a proportionate amount of excess limitation for tax purposes and carried forward as set forth below.

If a member fails to substantiate the member's proportionate share of the group's net interest expense, or a member so elects, the member's interest deduction would be limited to the member's interest income plus 10 percent of the member's adjusted taxable income (as defined under section 163(j)). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the ten-percent alternative, disallowed interest would be carried forward indefinitely and any excess limitation for a tax year would be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would be exempt from the application of section 163(j).

U.S. subgroups would be treated as a single member of a financial reporting group for purposes of applying the proposal. For this purpose, a U.S. subgroup is defined as any U.S. entity that is not owned directly or indirectly by another U.S. entity, and all members (domestic or foreign) that are owned directly or indirectly by such entity. If a U.S. member of a U.S. subgroup owns stock of one or more foreign corporations, this proposal would apply before the Administration's minimum tax proposal. Under the minimum tax proposal, a deduction for interest expense that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the applicable minimum tax rate, and no deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. tax is paid. Accordingly, based on the ordering rule set forth above, the U.S. subgroup's interest expense that remains deductible after the application of this proposal would then be subject to the limitations on deductibility set forth in the Administration's minimum tax proposal.

The proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group. The proposal also would not apply to financial reporting groups that would otherwise report less than \$5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year. Entities that are exempt from this proposal would remain subject to section 163(j).

The Secretary would be granted authority to issue any regulations necessary to carry out the purposes of the proposal, including coordinating the application of the proposal with other interest deductibility rules, defining financial services entities, permitting financial reporting groups to apply the proportionate share approach using the group's net interest expense for tax purposes rather than net interest expense reported in the group's financial statements, providing for the treatment of pass-through entities, and providing adjustments to the application of the proposal to address differences in functional currency of members. In addition, if a financial

reporting group does not prepare financial statements under U.S. GAAP or IFRS, it is expected that regulations generally would allow the use of financial statements prepared under other countries' generally accepted accounting principles in appropriate circumstances.

The proposal would be effective for taxable years beginning after December 31, 2015.



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

### **Current Law**

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

### **Reasons for Change**

On January 11, 2012, the White House released a report that details the emerging trend of “insourcing” and how companies are increasingly choosing to invest in the United States. Updating the figures in that report shows that real private fixed nonresidential investment has grown by about 32 percent (between 2009 and the third quarter of 2014). Since the beginning of 2010, manufacturing employment has risen by about 755,000 (between 2010 and the end of 2014), while manufacturing production has increased by approximately 3.23 percent on an annualized basis. In addition, continued productivity growth has made the United States more competitive in attracting businesses to invest and create jobs by reducing the relative cost of doing business compared to other countries.

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

### **Proposal**

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

In addition, to reduce tax benefits associated with U.S. companies’ moving jobs offshore, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business. For this purpose, outsourcing a U.S. trade or business means reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign corporation, no reduction would be allowed for any expenses

associated with moving a U.S. trade or business outside the United States.

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

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

## **REPEAL DELAY IN THE IMPLEMENTATION OF WORLDWIDE INTEREST ALLOCATION**

### **Current Law**

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

The rules for allocating and apportioning interest expense between U.S. and foreign-source gross income are based on the theory that money is fungible and, therefore, that interest expense is properly attributable to all investments of a taxpayer. These rules generally require allocating and apportioning interest expense on the basis of assets, by treating all members of an affiliated group of U.S. corporations as a single corporation. Because the definition of affiliated group only includes the U.S. members of a worldwide group of companies, the U.S. members are required to allocate their interest expense to their U.S. and foreign investments without taking into account any third party interest expense incurred by foreign members of the worldwide group. This inconsistent treatment of the domestic and foreign members of a worldwide group results in more U.S. interest expense being allocated to foreign-source gross income than would be warranted by the fungibility principle to the extent that the foreign members of the worldwide group have third party interest expense.

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

For purposes of the election, the worldwide affiliated group includes all U.S. corporations in an affiliated group as well as all controlled foreign corporations that would be members of such affiliated group if the group included all corporations (including foreign corporations and insurance companies) in which at least 80 percent of the vote and value of the stock is owned in the aggregate, either directly or indirectly by one or more other corporations included in the affiliated group.

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

### **Reasons for Change**

The Administration has included a separate proposal, *Impose a 19-Percent Minimum Tax on Foreign Income*, which would impose a per-country minimum tax on foreign income. Under that proposal, a taxpayer must allocate and apportion interest expense among foreign-source gross income subject to tax at the full U.S. statutory rate, foreign-source gross income subject to various rates of U.S. tax under the minimum tax, and foreign-source gross income on which no U.S. tax is paid. Interest expense allocated and apportioned to foreign-source gross income subject to the minimum tax would be deductible only at the applicable minimum tax rate, while no deduction would be permitted for interest expense allocated and apportioned to foreign-source gross income on which no U.S. tax is paid.

Absent the worldwide affiliated group election, certain taxpayers would be required to allocate a disproportionate amount of their interest expense to these various categories of foreign-source gross income than is warranted under the fungibility principle. Accelerating the availability of the election will allow taxpayers to more accurately allocate and apportion interest expense for all purposes for which the allocation is relevant, including for implementing the per-country minimum tax, as well as determining the foreign tax credit limitation for foreign-source income such as royalties and interest that would continue to be subject to tax at the full U.S. statutory rate.

### **Proposal**

The proposal would make the worldwide affiliated group election available for taxable years beginning after December 31, 2015.

## **EXTEND THE EXCEPTION UNDER SUBPART F FOR ACTIVE FINANCING INCOME**

### **Current Law**

In general, U.S. multinational companies do not pay U.S. tax on the profits earned by their foreign subsidiaries until these profits are repatriated. The rules of subpart F (sections 951-964) provide a limited exception to this general rule of deferral, by requiring certain United States shareholders of a controlled foreign corporation (CFC) to include in their income on a current basis certain narrowly defined categories of passive and other highly mobile income (subpart F income), regardless of whether the income is distributed by the CFC.

One category of subpart F income is foreign personal holding company income, which generally includes dividends, interest, rents and royalties. There are several exceptions to the definition of foreign personal holding company income, including a temporary exception for certain income that is derived in the active conduct of a banking, financing, or similar business and a temporary exception for certain income that is derived in the active conduct of an insurance business. These two exceptions, collectively referred to as the “active financing exception,” provide that qualified banking or financing income of an eligible CFC and qualified insurance income of a qualifying CFC is not foreign personal holding company income or foreign base company services income. In addition, the active financing exception provides that certain income of a qualifying insurance company is not subpart F income. The active financing exception applies to taxable years of foreign corporations beginning after December 31, 1998, and before January 1, 2015, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end.

### **Reasons for Change**

The active financing exception recognizes that insurance, banking, financing, and similar businesses are active businesses that regularly generate income, such as interest and dividends, of a type that, absent the active financing exception, would be treated as passive for purposes of subpart F. Under this exception, those types of income are treated as “active” income and therefore not subject to current U.S. tax, with certain limitations. Permanent extension of this expiring provision will allow U.S.-based financial and insurance groups to continue their active international operations without being subject to subpart F, while the Administration’s proposal, *Impose a 19-percent Minimum Tax on Foreign Income*, would ensure that these businesses cannot reduce effective tax rates below the minimum rate of 19 percent.

### **Proposal**

The temporary active financing exception would be made permanent.

## **EXTEND THE LOOK-THROUGH TREATMENT OF PAYMENTS BETWEEN RELATED CONTROLLED FOREIGN CORPORATIONS (CFCS)**

### **Current Law**

In general, U.S. multinational companies do not pay U.S. tax on the profits earned by their foreign subsidiaries until these profits are repatriated. The rules of subpart F (sections 951-964) provide a limited exception to this general rule of deferral, by requiring certain United States shareholders of a CFC to include in their income on a current basis certain narrowly defined categories of passive and other highly mobile income (subpart F income), regardless of whether the income is distributed by the CFC.

One category of subpart F income is foreign personal holding company income, which generally includes dividends, interest, rents and royalties. There are several exceptions to the definition of foreign personal holding company income, including a temporary exception for dividends, interest, rents, and royalties received or accrued by a CFC from a related CFC, to the extent such payments are attributable or properly allocable to income of the related CFC that is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States (the “look-through exception”). The look-through exception applies to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2015, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end.

### **Reasons for Change**

Absent the look-through exception, a CFC that made certain payments attributable to active foreign earnings to a related CFC would incur subpart F income taxable at the full U.S. statutory rate. The Administration’s proposal, *Impose a 19-percent Minimum Tax on Foreign Income*, would provide a more appropriate policy response to concerns regarding foreign-to-foreign payments by ensuring that such payments could not be used to shift income into entities with effective tax rates below the minimum tax rate of 19 percent.

### **Proposal**

The temporary subpart F “look-through” exception would be made permanent.

## **IMPOSE A 19-PERCENT MINIMUM TAX ON FOREIGN INCOME**

### **Current Law**

In general, U.S. multinational companies do not pay U.S. tax on the profits earned by their foreign subsidiaries until these profits are repatriated, at which time a credit for foreign income taxes paid is allowed in order to mitigate double taxation. Creditable foreign taxes include foreign income taxes paid by a foreign corporation if the U.S. company owns at least 10 percent of the voting stock of the foreign corporation. The rules of subpart F (sections 951 to 964) provide a limited exception to this general rule of deferral, by requiring certain United States shareholders of a controlled foreign corporation (CFC) to include in their income on a current basis certain narrowly defined categories of passive and other highly mobile income (subpart F income). Additionally, under the “high-tax exception” of section 954(b)(4), an item of income that would otherwise be subpart F income is excluded from subpart F income if the taxpayer elects to establish that such item was subject to an effective rate of foreign income tax greater than 90 percent of the maximum U.S. corporate income tax rate.

In order to prevent the inappropriate deferral of U.S. tax on CFC earnings and profits that do not give rise to subpart F income, sections 951(a) and 956 generally require United States shareholders of CFCs to include in their income on a current basis a portion of the CFC’s earnings and profits invested in certain United States property. Section 959 provides rules for excluding from the gross income of a United States shareholder earnings and profits distributed to the United States shareholder by a CFC to the extent the United States shareholder was previously subject to tax under subpart F on the distributed earnings and profits.

A foreign tax credit is only available for an amount paid by a taxpayer to a foreign country to the extent the amount does not exceed the taxpayer’s liability under foreign law for tax. This condition is met if the amount is determined by the taxpayer in a manner that is consistent with a reasonable application of foreign law in such a way as to reduce, over time, the taxpayer’s reasonably expected liability for foreign tax, and if the taxpayer exhausts all effective and practical remedies to reduce its foreign tax liability.

The foreign tax credit is limited to an amount equal to the pre-credit U.S. tax on the taxpayer’s foreign-source income. This foreign tax credit limitation is applied separately to foreign-source income in separate categories, i.e., the passive basket and the general basket. Expenses such as overhead and interest are allocated and apportioned to foreign-source income for the purpose of calculating the foreign tax credit limitation and can therefore potentially reduce allowable credits. Active royalties paid to a United States person, which are generally deductible abroad and subject to low or no withholding taxes, and dividends attributable to highly taxed active income are both included in the general basket, meaning that excess credits from highly taxed dividends can shield lower-taxed royalties from residual U.S. tax.

In addition, expenses that are attributable to investments in CFC stock, such as interest expense, may be currently deducted, even if U.S. taxation of the CFC’s income is deferred (although such deductions would reduce the foreign tax credit limitation).

## **Reasons for Change**

The opportunity to defer U.S. tax on CFC earnings, together with the ability to currently deduct expenses attributable to deferred earnings, provide U.S. multinationals with the incentive to locate production overseas and shift profits abroad, eroding the U.S. tax base. In addition, the current system discourages these companies from bringing low-tax foreign earnings back to the United States, because they would pay significant residual U.S. tax on the repatriated earnings after taking into account any foreign tax credits. At the same time, the current foreign tax credit system allows companies to utilize credits from high-tax foreign-source income such as dividends to reduce U.S. tax on low-tax foreign-source income such as royalties. Finally, it may be difficult for the IRS to verify that a taxpayer has exhausted practical remedies under foreign law to reduce its reasonably expected foreign tax liability over time in a manner consistent with a reasonable interpretation of foreign law.

## **Proposal**

The Administration proposes to supplement the existing subpart F regime with a per-country minimum tax on the foreign earnings of entities taxed as domestic C corporations (U.S. corporations) and their CFCs. The minimum tax would apply to a U.S. corporation that is a United States shareholder of a CFC or that has foreign earnings from a branch or from the performance of services abroad. Under the proposal, the foreign earnings of a CFC or branch or from the performance of services would be subject to current U.S. taxation at a rate (not below zero) of 19 percent less 85 percent of the per-country foreign effective tax rate (the residual minimum tax rate). The foreign effective tax rate would be computed on an aggregate basis with respect to all foreign earnings and the associated foreign taxes assigned to a country (as described below) for the 60-month period that ends on the date on which the domestic corporation's current taxable year ends, or in the case of CFC earnings, that ends on the date on which the CFC's current taxable year ends. For this purpose, the foreign taxes taken into account are those taxes that, absent the proposal, would be eligible to be claimed as a foreign tax credit during the 60-month period. Furthermore, subject to rules applicable to hybrid arrangements (as described below), the foreign earnings taken into account for the 60-month period would be determined under U.S. tax principles but would include disregarded payments deductible elsewhere, such as disregarded intra-CFC interest or royalties, and would exclude dividends from related parties.

The country to which foreign earnings and associated foreign taxes are assigned is based on tax residence under foreign law. For example, if a CFC is incorporated in Country X but a tax resident of Country Y under both the Country X and Country Y place of management tests for tax residence, the CFC's earnings and associated foreign taxes would be assigned to Country Y for purposes of computing the minimum tax. If instead Country Y used a place of incorporation test such that the CFC is stateless and is not subject to foreign tax anywhere, the CFC's earnings would be subject to the minimum tax at the full 19-percent rate. Earnings and taxes of a particular CFC may be allocated to multiple countries if it has earnings subject to tax in different countries. Where the same earnings of a CFC are subject to tax in multiple countries, the earnings and all of the foreign taxes associated with those earnings would be assigned to the highest-tax country. For example, if a CFC incorporated in high-tax Country Z has a permanent



establishment in low-tax Country Q and both Country Z and Country Q tax the earnings of the permanent establishment, the earnings and both the Country Z taxes and the Country Q taxes associated with those earnings would be assigned to Country Z.

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

The tentative minimum tax base would be reduced by an allowance for corporate equity (ACE). The ACE allowance would provide a risk-free return on equity invested in active assets, which generally would include assets that do not generate foreign personal holding company income (determined without regard to both the look-through rule of section 954(c)(6) and any election to disregard an entity as separate from its owner). Thus, the ACE allowance is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.

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

The minimum tax would be imposed on current foreign earnings regardless of whether they are repatriated to the United States, and all foreign earnings could be repatriated without further U.S. tax. Thus, under the proposal, U.S. tax would be imposed on a CFC's earnings either immediately (either under subpart F or the minimum tax) or not at all (if the income was subject to sufficient foreign tax or was exempt pursuant to the ACE allowance). Subpart F generally would continue to require a United States shareholder of a CFC to include in its gross income on a current basis, at the full U.S. tax rate (with foreign tax credits available as provided under current law), the shareholder's share of the CFC's subpart F income, but the subpart F high-tax exception would be made mandatory for United States shareholders that are U.S. corporations.

Additionally, no U.S. tax would be imposed on the sale by a United States shareholder of stock of a CFC to the extent any gain reflects the undistributed earnings of the CFC, which generally would have already been subject to tax under the minimum tax, subpart F, or the 14-percent one-time tax under the Administration's separate proposal, *Impose a 14-Percent One-Time Tax on Previously Untaxed Income*. In addition, to avoid creating a bias that would affect a United States shareholder's decision whether to sell CFC stock or continue to own it (and therefore continue to be subject to U.S. taxation on the CFC's earnings under the minimum tax and subpart F), any stock gain that is attributable to unrealized (and therefore untaxed) gain in the CFC's assets would be subject to U.S. tax in the same manner as would apply to the future earnings from those assets. Accordingly, stock gain would be subject to the minimum tax or to tax at the

full U.S. rate to the extent it reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or subpart F, respectively.

Foreign-source royalty and interest payments received by U.S. corporations would continue to be taxed at the full U.S. statutory rate but, in contrast with current law, could not be shielded by excess foreign tax credits associated with dividends from high-tax CFCs because the earnings of high-tax CFCs would be exempt from U.S. tax. A foreign branch of a U.S. corporation would be treated like a CFC. Accordingly, to the extent the foreign branch used the intangibles of its owner, the branch would be treated as making royalty payments to its owner that are recognized for U.S. tax purposes. Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid. Rules regarding CFC investments in United States property and previously taxed earnings would be repealed for United States shareholders that are U.S. corporations.

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

The proposal would be effective for taxable years beginning after December 31, 2015.

## **IMPOSE A 14-PERCENT ONE-TIME TAX ON PREVIOUSLY UNTAXED FOREIGN INCOME**

### **Current Law**

In general, U.S. multinational companies do not pay U.S. tax on the profits earned by their foreign subsidiaries until these profits are repatriated. Under current law, the rules of subpart F (sections 951-964) provide a limited exception to this general rule of deferral, by requiring certain United States shareholders of a controlled foreign corporation (CFC) to include in their income on a current basis certain narrowly defined categories of passive and other highly mobile income, regardless of whether the income is distributed to the shareholders.

### **Reasons for Change**

The opportunity under current law for U.S. multinationals to defer U.S. tax on earnings of their CFCs has given rise to the accumulation of substantial amounts of earnings in CFCs subject to low effective tax rates. Under the Administration's proposal for companies to pay a minimum tax on overseas profits, no U.S. tax would be imposed on a CFC's future payment of a dividend. Accordingly, a transition measure is necessary to provide that previously accumulated deferred earnings also are subject to U.S. tax.

### **Proposal**

In connection with the transition to the minimum tax, this proposal would impose a one-time 14-percent tax on earnings accumulated in CFCs and not previously subject to U.S. tax. A credit would be allowed for the amount of foreign taxes associated with such earnings multiplied by the ratio of the one-time tax rate to the maximum U.S. corporate tax rate for 2015. The accumulated income subject to the one-time tax could then be repatriated without any further U.S. tax. The proposal pays for outlays associated with: (1) new spending associated with the Administration's surface transportation reauthorization proposal; and (2) shortfalls between revenue and surface transportation spending that exist under current law for the proposal period.

The proposal would be effective on the date of enactment and would apply to earnings accumulated for taxable years beginning before January 1, 2016. The tax would be payable ratably over five years.

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

### **Current Law**

The Secretary may distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever “necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses” (section 482). In the case of transfers of intangible property (as defined in section 936(h)(3)(B)), section 482 also provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible property. Further, under section 367(d), if a U.S. person transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in a transaction that would otherwise be tax-free under section 351 or section 361, the U.S. person is treated as (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of the property, and (ii) receiving amounts which reasonably reflect the amounts which would have been received annually in the form of such payments over the useful life of the property, or, in the case of a disposition following such transfer, at the time of the disposition. The amounts taken into account shall be commensurate with the income attributable to the intangible. Finally, under the regulations issued pursuant to section 367(e)(2), if a U.S. subsidiary corporation transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign parent corporation in an otherwise tax-free liquidation described in section 332, the U.S. subsidiary must recognize gain upon the distribution of such property.

### **Reasons for Change**

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

### **Proposal**

The proposal would provide that the definition of intangible property under section 936(h)(3)(B) (and therefore for purposes of sections 367 and 482) also includes workforce in place, goodwill, and going concern value, and any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual. The proposal also would clarify that where multiple intangible properties are transferred, or where intangible property is transferred with other property or services, the Commissioner of the IRS may value the properties or services on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the Commissioner of the IRS may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The proposal would be effective for taxable years beginning after December 31, 2015.

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

The provision would be effective for policies issued in taxable years beginning after December 31, 2015.

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

### **Current Law**

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

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

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

### **Reasons for Change**

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

### **Proposal**

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

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

The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would be effective for amounts that, if such amounts were an amount of tax paid or accrued, would be considered paid or accrued in taxable years beginning after December 31, 2015. The aspect of the proposal that would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 would be effective for taxable years beginning after December 31, 2015.

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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



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

The proposal would be effective for sales or exchanges after December 31, 2015.

## **MODIFY SECTIONS 338(h)(16) AND 902 TO LIMIT CREDITS WHEN NON-DOUBLE TAXATION EXISTS**

### **Current Law**

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

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

Sections 902 and 960 provide that a domestic corporation owning at least 10 percent of the voting stock of a foreign corporation is allowed a credit for foreign taxes paid by a foreign corporation if the domestic corporation receives a dividend distribution from the foreign corporation or an income inclusion under subpart F that is treated as a dividend for purposes of section 902. Regulations under section 367(b) provide rules for the allocation of earnings and profits and foreign taxes of a foreign corporation in transactions described in section 381.

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

### **Reasons for Change**

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

The reduction, allocation, or elimination of a corporation's earnings and profits in a transaction without a corresponding reduction in the corporation's associated foreign taxes paid would result in a corporate shareholder of the corporation claiming an indirect credit under section 902 for foreign taxes paid with respect to earnings that will no longer fund a dividend distribution for U.S. tax purposes.

### **Proposal**

#### Extend section 338(h)(16) to certain asset acquisitions

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

#### Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated

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

The proposal would be effective for transactions occurring after December 31, 2015.

## **CLOSE LOOPHOLES UNDER SUBPART F**

### **Current Law**

If a foreign corporation is a controlled foreign corporation (CFC) for an uninterrupted period of 30 days or more during a taxable year (“the 30-day rule”), every person who is a United States shareholder of the corporation, and who owns stock in the corporation on the last day in such corporation’s taxable year on which such corporation is a CFC, must currently include in its gross income its pro-rata share of the subpart F income earned by the CFC during that year. In addition, in order to prevent the inappropriate deferral of U.S. tax on CFC earnings and profits that do not give rise to subpart F income, a United States shareholder of a CFC is required to include in income on a current basis its pro rata share of the CFC’s earnings and profits invested in United States property.

A foreign corporation is a CFC if more than 50 percent of the total combined voting power or value of the corporation’s stock is owned by United States shareholders on any day during a taxable year of the corporation. A United States shareholder means, with respect to a foreign corporation, a U.S. person that owns directly or indirectly (within the meaning of section 958(a)), or is considered as owning under the constructive ownership rules of section 958(b), ten percent or more of the total combined voting power of the corporation’s stock.

Section 958(b) applies the constructive ownership rules of section 318, with certain modifications. One of those modifications turns off downward attribution of stock from a foreign person to a U.S. person. As a result, if a foreign person is a partner in a U.S. partnership, a beneficiary in a U.S. trust, or a shareholder in a U.S. corporation, the partnership, trust, or corporation, as applicable, is not considered to own stock in a foreign corporation that such foreign person owns, directly or indirectly, for purposes of determining whether such partnership, trust, or corporation is a United States shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. For example, if a U.S. corporation is a wholly-owned subsidiary of a foreign parent corporation, and the U.S. corporation and the foreign parent corporation each directly own 50 percent (vote and value) of the stock of another foreign corporation, the U.S. corporation is considered to own only 50 percent (vote and value) of the stock of such other foreign corporation and is not considered to own the stock that is owned by the foreign parent corporation for purposes of determining whether the U.S. corporation is a United States shareholder of the foreign corporation.

Subpart F income includes certain passive and other highly mobile income. Specifically, subpart F income includes, among other things, “foreign base company income,” which, in turn, includes foreign personal holding company income, foreign base company sales income, and foreign base company services income. Foreign personal holding company income generally includes rents and royalties other than those received from an unrelated person in the active conduct of a trade or business. Foreign base company sales income generally includes income earned in connection with a purchase and subsequent sale of personal property where such property is purchased from (or on behalf of), or sold to (or on behalf of), a related person, provided the property is manufactured outside of the CFC’s country of organization and sold for use or consumption outside that country. Foreign base company services income generally includes income earned

in connection with the performance of certain services performed outside of the CFC's country of organization for or on behalf of a related person. These categories of subpart F income are intended to ensure that tax is not deferred on income that is not generated by an active trade or business of the CFC.

Digital transactions involving copyrighted articles can take the form of leases, sales, or services. For example, a transaction involving a transfer of a computer program (i.e., a copyrighted article) could be characterized as a sale or lease of the computer program, depending on the facts and circumstances concerning the benefits and burdens of ownership with respect to the computer program. A computer program hosted on a server also might be used in a transaction characterized as the provision of a service to a user who accesses the server from a remote location.

### **Reasons for Change**

The existing categories of subpart F income, and the threshold requirements for applying subpart F, rely on technical distinctions that may be manipulated or circumvented contrary to subpart F's policy of requiring current U.S. taxation of passive and other highly mobile income earned by foreign corporations controlled by U.S. taxpayers. For example, by choosing different forms for substantially similar transactions, taxpayers may be able to avoid the application of subpart F. In addition, taxpayers exploit the 30-day rule by intentionally generating significant subpart F income during short taxable years of less than 30 days (e.g., through a section 338(g) election in which the transaction is structured to occur within fewer than 30 days of the start of a CFC's taxable year).

In addition, when a U.S.-parented group is acquired by a foreign corporation, the new foreign parent (or a non-CFC foreign affiliate of the foreign parent) may acquire a sufficient amount of the stock of one or more foreign subsidiaries of the former U.S.-parented group to cause such foreign subsidiaries to cease to be CFCs, so as to avoid the application of subpart F with respect to the continued ownership interest of the United States shareholders. For example, this result could be achieved, while also avoiding the recognition of income for U.S. income tax purposes, by having the new foreign parent issue a note or transfer property to a CFC in exchange for stock representing at least 50 percent of the voting power and value of the CFC. As a result, subpart F would no longer apply to the United States shareholders' continued ownership interest in the former CFC, even though the worldwide group controls the entity and is therefore in a position to use it to shift passive and other highly mobile income from the former U.S. group.

### **Proposal**

The proposal would expand the categories of subpart F income in two ways:

#### **Create a new category of subpart F income for transactions involving digital goods or services**

First, the proposal would create a new category of subpart F income, foreign base company digital income, which generally would include income of a CFC from the lease or sale of a digital copyrighted article or from the provision of a digital service, in cases where the CFC uses

intangible property developed by a related party (including property developed pursuant to a cost sharing arrangement) to produce the income and the CFC does not, through its own employees, make a substantial contribution to the development of the property or services that give rise to the income. An exception would apply where the CFC earns income directly from customers located in the CFC's country of incorporation that use or consume the digital copyrighted article or digital service in such country.

#### Expand foreign base company sales income to include manufacturing services arrangements

Second, the proposal would expand the category of foreign base company sales income to include income of a CFC from the sale of property manufactured on behalf of the CFC by a related person. The existing exceptions to foreign base company sales income would continue to apply.

Additionally, the proposal would modify the thresholds for applying subpart F in two ways:

#### Amend CFC attribution rules

First, the proposal would amend the ownership attribution rules of section 958(b) so that certain stock of a foreign corporation owned by a foreign person is attributed to a related United States person for purposes of determining whether the related United States person is a United States shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. The pro rata share of a CFC's subpart F income that a United States shareholder is required to include in gross income, however, would continue to be determined based on direct or indirect ownership of the CFC, without application of the ownership attribution rules of section 958(b).

#### Eliminate the 30-day grace period before subpart F inclusions

Second, the proposal would eliminate the requirement for a foreign corporation to be a CFC for an uninterrupted period of at least 30 days in order for a United States shareholder to be required to include in its gross income currently subpart F income earned by the CFC.

The proposals would be effective for taxable years beginning after December 31, 2015.

## **RESTRICT THE USE OF HYBRID ARRANGEMENTS THAT CREATE STATELESS INCOME**

### **Current Law**

Subject to certain exceptions and limitations, interest and royalty payments made or incurred in carrying on a trade or business are generally deductible under current law without regard to the tax treatment of such payments in other jurisdictions.

In general, U.S. multinational companies do not pay U.S. tax on the profits earned by their foreign subsidiaries until these profits are repatriated. The rules of subpart F (sections 951-964) provide a limited exception to this general rule, by requiring United States shareholders of CFCs to include in their income on a current basis certain narrowly defined categories of income of the CFC (subpart F income), regardless of whether the income is distributed to the shareholders. Subpart F income includes passive items of income such as dividends, interest, rents and royalties.

One exception from subpart F income applies to certain dividend and interest income received from a related corporation created or organized and operating in the same country as the CFC receiving the income (the same-country exception in section 954(c)(3)). In addition, the same-country exception provides that certain rents and royalties received from a related corporation for the use of property within the country under the laws of which the CFC receiving the income is created or organized are not included in subpart F income. A temporary provision (section 954(c)(6)) provided another exception to subpart F income (the look-through exception) for certain dividends, interest, rents and royalties received from a related CFC to the extent such income is attributable or properly allocable to income of the related CFC that is neither subpart F income nor income effectively connected with the conduct of a trade or business within the United States. The look-through exception expired on December 31, 2014.

### **Reasons for Change**

There has been a proliferation of tax avoidance techniques involving a variety of cross-border hybrid arrangements, such as hybrid entities, hybrid instruments, and hybrid transfers (e.g., a sale-repurchase or “repo” transaction, in which the parties take inconsistent positions regarding the ownership of the same property). Taxpayers use such arrangements either to claim deductions in one jurisdiction without a corresponding inclusion anywhere else, resulting in “stateless” income, or to claim multiple deductions for the same payment in different jurisdictions.

In one such hybrid arrangement, a U.S. person holds an interest in a reverse hybrid, which is an entity that is a corporation for U.S. tax purposes but is a fiscally transparent entity (such as a partnership) or a branch under the laws of a foreign jurisdiction. Because the United States treats the reverse hybrid as a corporation, income earned by the reverse hybrid generally will not be subject to current U.S. tax. Moreover, even if the reverse hybrid is treated as a CFC, interest and royalty income earned by the reverse hybrid from certain foreign related persons (which otherwise would qualify as subpart F income) may nonetheless not be subject to current U.S.

taxation as a result of either section 954(c)(3) or section 954(c)(6). Payments to the reverse hybrid, however, generally are also not subject to tax in the foreign jurisdiction in which it is established or organized, because the foreign jurisdiction views the reverse hybrid as a fiscally transparent entity and therefore treats that entity's income as derived by its owners, including its U.S. owners. As a result of this hybrid treatment, income earned by the reverse hybrid generally would not be subject to tax currently in either the United States or the foreign jurisdiction.

## **Proposal**

### **Restrict the use of hybrid arrangements that create stateless income**

The proposal would deny deductions for interest and royalty payments made to related parties under certain circumstances involving a hybrid arrangement, including if either (i) as a result of the hybrid arrangement, there is no corresponding inclusion to the recipient in the foreign jurisdiction or (ii) the hybrid arrangement would permit the taxpayer to claim an additional deduction for the same payment in another jurisdiction.

The Secretary would be granted authority to issue any regulations necessary to carry out the purposes of this proposal, including regulations that would (1) deny deductions from certain conduit arrangements that involve a hybrid arrangement between at least two of the parties to the conduit arrangement; (2) deny interest or royalty deductions arising from certain hybrid arrangements involving unrelated parties in appropriate circumstances, such as structured transactions; and (3) deny all or a portion of a deduction claimed with respect to an interest or royalty payment that, as a result of the hybrid arrangement, is subject to inclusion in the recipient's jurisdiction pursuant to a preferential regime that has the effect of reducing the generally applicable statutory rate by at least 25 percent.

### **Limit the application of exceptions under subpart F for certain transactions that use reverse hybrids to create stateless income**

Additionally, the proposal would provide that sections 954(c)(3) and 954(c)(6) would not apply to payments made to a foreign reverse hybrid owned directly by one or more U.S. persons when such amounts are received from foreign related persons that claim a deduction for foreign tax purposes with respect to the payment.

The proposal would be effective for taxable years beginning after December 31, 2015.



## **LIMIT THE ABILITY OF DOMESTIC ENTITIES TO EXPATRIATE**

### **Current Law**

Section 7874 applies to certain transactions (known as “inversion transactions”) in which a U.S. corporation is replaced by a foreign corporation (“foreign acquiring corporation”) as the parent company of a worldwide affiliated group of companies in a transaction where (i) substantially all of the assets of a domestic corporation are acquired by a foreign acquiring corporation; (ii) the historical owners of the domestic corporation retain at least a 60-percent ownership interest in the foreign acquiring corporation; and (iii) the foreign acquiring corporation, together with the expanded affiliated group that includes the foreign acquiring corporation (EAG), does not conduct substantial business activities in the country in which it is created or organized. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the property constituting a trade or business of a domestic partnership.

The tax consequences of an inversion transaction depend on the level of shareholder continuity. If the continuing ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80 percent or more (by vote or value), the new foreign parent corporation is treated as a domestic corporation for all U.S. tax purposes (the “80-percent test”). If the continuing shareholder ownership is at least 60 percent but less than 80 percent, the foreign status of the acquiring corporation is respected but certain other adverse tax consequences apply, including the inability to use tax attributes to reduce certain corporate-level income or gain (“inversion gain”) recognized by the expatriated group (the “60-percent test”).

### **Reasons for Change**

In order to reduce their U.S. taxes, domestic entities have with greater frequency been combining with smaller foreign entities such that the level of continued ownership of the historical shareholders of the domestic entity is less than 80 percent (although above the 60-percent threshold). The combination is typically structured so that the domestic entity and the foreign entity will be subsidiaries of a newly formed foreign parent company located in a low-tax jurisdiction. The domestic entities engaging in these transactions often emphasize that the transaction is expected to substantially reduce the U.S. tax liability of the multinational group with only minimal changes to its operations. Inversion transactions raise significant policy concerns because they facilitate the erosion of the U.S. tax base through deductible payments by the remaining U.S. members of the multinational group to the non-U.S. members and through aggressive transfer pricing for transactions between such U.S. and non-U.S. members. The inverted group also may reduce its U.S. taxes by causing its foreign subsidiaries to cease to qualify as controlled foreign corporations in order to avoid U.S. taxation under subpart F of the Code on passive and other highly mobile income that is shifted to the foreign subsidiaries.

The adverse tax consequences under current law of 60-percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base. Furthermore, an inverted structure should not be respected when the structure

results from the combination of a larger U.S. group with a smaller entity or group and, after the transaction, the EAG is primarily managed and controlled in the United States and does not have substantial business activities in the relevant foreign country, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group.

Concerns about inversions have led to the enactment of statutory rules that require certain Federal agencies not to contract with multinational groups that have inverted. Federal agencies, however, generally do not have access to the identity of such groups. To the extent the IRS has or is authorized to collect this information, the IRS would be restricted under section 6103 from sharing it with other Federal agencies.

### **Proposal**

To limit the ability of domestic entities to expatriate, the proposal would broaden the definition of an inversion transaction by reducing the 80-percent test to a greater than 50-percent test, and eliminating the 60-percent test. The proposal also would add a special rule whereby, regardless of the level of shareholder continuity, an inversion transaction would occur if (i) immediately prior to the acquisition, the fair market value of the stock of the domestic entity is greater than the fair market value of the stock of the foreign acquiring corporation, (ii) the EAG is primarily managed and controlled in the United States, and (iii) the EAG does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized. Additionally, the proposal would expand the scope of acquisitions described in section 7874 so that an inversion transaction could occur if there is a direct or indirect acquisition of substantially all of the assets of a domestic corporation or domestic partnership, substantially all of the trade or business assets of a domestic corporation or domestic partnership, or substantially all of the U.S. trade or business assets of a foreign partnership.

In addition, the proposal would provide the IRS with authority to share tax return information with Federal agencies for the purpose of administering an agency's anti-inversion rules. Federal agencies receiving this information would be subject to the safeguarding and recordkeeping requirements under section 6103.

The proposals that would limit the ability of domestic entities to expatriate would be effective for transactions that are completed after December 31, 2015. The proposal providing the IRS with the authority to share information with other Federal agencies to assist them in identifying companies that were involved in an inversion transaction would be effective January 1, 2016, without regard to when the inversion transaction occurred.

## **SIMPLIFICATION AND TAX RELIEF FOR SMALL BUSINESS**

### **EXPAND AND PERMANENTLY EXTEND INCREASED EXPENSING FOR SMALL BUSINESS**

#### **Current Law**

Section 179 provides that, in place of capitalization and depreciation, taxpayers may elect to deduct a limited amount of the cost of qualifying depreciable property placed in service during a taxable year. The deduction limit is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds a specified threshold amount. The maximum deduction amount and the beginning of the phase-out range have been adjusted several times in recent years. For qualifying property placed in service in taxable years beginning in 2007, the maximum deduction amount was \$125,000, but this level was reduced by the amount that a taxpayer's qualifying investment exceeded \$500,000. For taxable years 2008 and 2009, the maximum deduction was changed to \$250,000, with the phase-out beginning at \$800,000 of qualifying investment, and for 2010 and 2011, these amounts were changed to \$500,000 and \$2 million, respectively. The American Taxpayer Relief Act of 2012 continued the 2011 amounts through 2013, and the Tax Increase Prevention Act of 2014 extended them through 2014. For qualifying property placed in service in taxable years beginning after 2014, the limits revert to pre-2003 law, with \$25,000 as the maximum deduction and \$200,000 as the beginning of the phase-out range, with no indexing for inflation.

Qualifying property is defined generally as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. However, only \$25,000 of the cost of any sport utility vehicle may be taken into account. For taxable years beginning after 2002 and before 2015, off-the-shelf computer software is considered qualifying property. For taxable years 2010 through 2014, the definition of qualifying property also includes certain real property, such as leasehold improvement property, restaurant property, and retail improvement property, but the maximum amount of the cost of such real property that may be expensed is \$250,000.

The amount allowed as a deduction for any taxable year cannot exceed the taxable income of the taxpayer (computed without regard to the section 179 deduction) that is derived from the active conduct of a trade or business for that taxable year. Deductions disallowed because of this limitation may be carried forward to the following taxable year, except that disallowed amounts allocated to real property investments may not be carried over to a taxable year beginning after 2014.

A section 179 election is currently revocable by the taxpayer with respect to any property, but such revocation, once made, is irrevocable. However, an election made with respect to a taxable year beginning after 2014 will not be revocable, except with the consent of the Secretary.

#### **Reasons for Change**

Making permanent the section 179 limits would achieve several goals. It would provide stability for business planning. By expensing capital purchases, it would reduce the after-tax cost relative

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

### **Proposal**

The proposal would extend the 2014 section 179 expensing and investment limitations, effective for qualifying property placed in service in taxable years beginning after December 31, 2014. For qualifying property placed in service in taxable years beginning after December 31, 2015, the maximum amount that can be expensed would be increased to \$1 million and this deduction would be reduced by the amount that a taxpayer's qualifying investment exceeded \$2 million (but not below zero). The limits would be indexed for inflation in taxable years beginning after December 31, 2016, as would the dollar limitation on the expensing of sport utility vehicles. Qualifying property would permanently include off-the-shelf computer software, but would not include real property. An election under section 179 would be revocable by the taxpayer with respect to any property, but such revocation, once made, would be irrevocable.

The proposal would be effective for qualifying property placed in service in taxable years beginning after December 31, 2014.

## **EXPAND SIMPLIFIED ACCOUNTING FOR SMALL BUSINESS AND ESTABLISH A UNIFORM DEFINITION OF SMALL BUSINESS FOR ACCOUNTING METHODS**

### **Current Law**

Certain businesses are not allowed to use the cash accounting method and must use an accrual method of accounting. These entities include corporations other than S corporations (“C corporations”), partnerships with a C corporation as a partner, and certain tax shelters. Qualified personal service corporations may nevertheless use the cash method, as can nonfarm corporations if they had \$5 million or less in average annual gross receipts for each three-taxable-year period ending in all prior taxable years that began after December 31, 1985. C corporations engaged in the business of farming may use the cash method if they had \$1 million or less in annual gross receipts for each prior taxable year beginning after December 31, 1975. A family-owned farming corporation may use the cash method if it had \$25 million or less in annual gross receipts for each prior taxable year beginning after December 31, 1985.

Taxpayers generally must capitalize costs incurred in the production of real or personal property and in the production or purchase of inventory. The Code’s uniform capitalization (UNICAP) rules require that these capitalized costs include both direct costs and an allocable portion of indirect production and acquisition costs. The UNICAP rules do not apply to a taxpayer acquiring personal property for resale if the taxpayer had \$10 million or less in average annual gross receipts for the three-taxable year period ending with the immediately preceding taxable year. Producers using a simplified production method for determining indirect production costs, and having \$200,000 or less of those costs in a taxable year, are not required to capitalize those costs. Exceptions from the UNICAP rules also apply to certain specified property and expenses, including animals and certain plants produced in a farming business, unless the farming business is required to use an accrual method of accounting. Finally, the UNICAP rules do not apply to inventory items of qualifying small business taxpayers.

A taxpayer must account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer’s business, and an accrual method of accounting must be used with regard to purchases and sales anytime inventory accounting is necessary. Two types of qualifying small taxpayers with inventories may use the cash method of accounting, and may deduct the cost of items purchased for resale and of raw materials purchased for use in producing finished goods in the year the related merchandise is sold, or, if later, in the year in which the taxpayer actually pays for the items: (1) any taxpayer (other than a tax shelter) that had average annual gross receipts of \$1 million or less for the three-taxable year period ending with each prior taxable year ending on or after December 17, 1998, and (2) a taxpayer (other than a farming business) that would not be prohibited from using the cash method under the rules described above and that had \$10 million or less in average annual gross receipts for the three-taxable year period ending with each prior taxable year ending on or after December 31, 2000. In general, a taxpayer in this second group qualifies only if its business activity is not classified as mining, manufacturing, wholesale or retail trade, or an information industry activity.

## **Reasons for Change**

Current law rules have non-uniform small business exception requirements, relying on varying forms of gross receipts tests, with widely different exception thresholds, and different rules depending on the classification of a taxpayer's business activities. A uniform definition of small business for determining applicable accounting rules and a consistent application of a gross receipts test would simplify tax administration and taxpayer compliance. An increase in the exception threshold amount of a taxpayer's average annual gross receipts to \$25 million would increase the number of business entities that would be able to obtain relief from complex tax accounting rules, many of which are not used for financial accounting. Many rules under current law prohibit a taxpayer from taking advantage of an accounting exception if they ever fail to meet the relevant gross receipts test. Such taxpayers should be allowed to avail themselves of simplified accounting methods if they subsequently are able to meet the gross receipts test for a specified number of years. Finally, indexing the threshold for inflation ensures that the small business definition remains a current reflection of the appropriate level of gross receipts for excepting entities from certain tax accounting rules.

## **Proposal**

The Administration proposes to create a uniform small business threshold at \$25 million in average annual gross receipts for allowing exceptions from certain accounting rules, effective for taxable years beginning after December 31, 2015. This threshold would be indexed for inflation with respect to taxable years beginning after December 31, 2016. Average annual gross receipts would be determined over a three-year period, ending with the taxable year prior to the current taxable year. Adjustments would be made for taxpayers not having sufficient receipts history. All entities treated as a single employer under existing law would be treated as a single entity for purposes of the gross receipts test. Satisfaction of the gross receipts test would allow an entity to elect one or more of the following items: (1) use of the cash method of accounting in lieu of an accrual method (regardless of whether the entity holds inventories); (2) the non-application of the uniform capitalization (UNICAP) rules; and (3) the use of an inventory method of accounting that either conforms to the taxpayer's financial accounting method or is otherwise properly reflective of income, such as deducting the cost of inventory items in the year the related merchandise is sold. A business whose average annual gross receipts exceeds the threshold would not be able to make an election to use one or more simplified accounting methods for the current taxable year and the following four taxable years. These rules would supersede the special cash method exception rules that apply to farm corporations, but exceptions allowing the cash method by personal service corporations and by business entities that are not C corporations (other than partnerships with a C corporate partner), regardless of size, would continue. Any tax shelter would continue to be required to use an accrual accounting method. The exceptions from UNICAP not based on a gross receipts test would continue. The UNICAP farming exceptions would not be changed, but would be affected by the new gross receipts threshold for excepting UNICAP requirements altogether for produced property, as well as the higher threshold for requiring use of an accrual accounting method.

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

### **Current Law**

Under the Small Business Jobs Act of 2010, section 1202 was amended so that taxpayers other than corporations may exclude 100 percent of the gain from the sale of “qualified small business stock” acquired after September 27, 2010 and before January 1, 2011, and held for at least five years, provided various requirements are met. The 100-percent exclusion provision was extended several times and under current law applies to eligible stock acquired after September 27, 2010 and before January 1, 2015. In addition, the excluded gain is not a preference under the Alternative Minimum Tax (AMT) for eligible stock acquired after September 27, 2010 and before January 1, 2015.

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

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

The corporation also must meet certain active trade or business requirements. For example, the corporation must be engaged in a trade or business other than: one involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of the trade or business is the reputation or skill of one or more employees; a banking, insurance, financing, leasing, investing or similar business; a farming business; a business involving production or extraction of items subject to depletion; or a hotel, motel, restaurant, or similar business. There are limits on the amount of real property that may be held by a qualified small business, and ownership of, dealing in, or renting real property is not treated as an active trade or business.

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

## **Reasons for Change**

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

## **Proposal**

The proposal would make the 100-percent exclusion for qualified small business stock permanent. The AMT preference item for gain excluded under section 1202 would be repealed for all excluded gain on qualified small business stock. In addition to the current 60-day rollover period under section 1045, a new six-month rollover period is proposed for taxpayers to reinvest the proceeds from sales of qualified small business stock held longer than three years. Other limitations on the section 1202 exclusion would continue to apply. The proposal would clarify that small business stock can include stock acquired upon the exercise of warrants and options if such stock rights are acquired at original issue from the corporation, and that all relevant holding periods for such stock start on the date the stock is issued by the corporation to the taxpayer. The proposal would include additional information reporting requirements to assure compliance with those limitations, and taxpayers would be required to report qualified sales on their tax returns.

The proposal would be effective for qualified small business stock acquired after December 31, 2014.



## **INCREASE THE LIMITATIONS FOR DEDUCTIBLE NEW BUSINESS EXPENDITURES AND CONSOLIDATE PROVISIONS FOR START-UP AND ORGANIZATIONAL EXPENDITURES**

### **Current Law**

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

Organizational expenditures (under sections 248 and 709) are expenditures that are incident to the creation of a corporation or partnership, chargeable to a capital account, and are of a character which, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

In general, a taxpayer may elect to deduct up to \$5,000 of start-up expenditures in the taxable year in which the active trade or business begins, and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the active trade or business begins. The \$5,000 amount is reduced (but not below zero) by the amount by which such start-up expenditures exceed \$50,000. Similarly, a taxpayer may elect to deduct up to \$5,000 of organizational expenditures in the taxable year in which the corporation or partnership begins business, and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the corporation or partnership begins business. The \$5,000 amount is reduced (but not below zero) by the amount by which such corporate or partnership organizational expenditures exceed \$50,000.

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

### **Reasons for Change**

An immediate deduction of new business expenditures lowers the tax cost of investigating new business opportunities and investing in new business activities. Increasing the dollar limit on expensed new business expenditures and increasing the phase-out amount would support new business formation and job creation. Consolidating the Code provisions relating to expenditures incurred by new businesses simplifies tax administration and reduces new business owners' tax compliance burden.

## **Proposal**

The Administration proposes to permanently allow up to \$20,000 of new business expenditures to be deducted in the taxable year in which a trade or business begins and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the business begins. This maximum amount of expensed new business expenditures would be reduced (but not below zero) by the amount by which new business expenditures with respect to the business exceed \$120,000. New business expenditures would include amounts incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and (4) expenditures that are incident to the creation of an entity taxed as a corporation or partnership, that are chargeable to a capital account and are of a character which, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

The proposal would be effective for taxable years beginning after December 31, 2015.

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

### **Current Law**

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

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

The Affordable Care Act created a tax credit to help small employers provide health insurance for employees and their families. An employer must make uniform contributions of at least 50 percent of the premium to qualify for the credit. For taxable years beginning in 2010 through 2013, the credit was available for any health insurance coverage purchased from an insurance company licensed under State law. For taxable years beginning after December 31, 2013, the credit is generally available only for the two-consecutive-taxable year period beginning with the first taxable year in which the employer both offers a qualified health plan to its employees through a small business health options program (SHOP) and claims the credit.

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

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

During 2010 through 2013, the maximum credit was 35 percent (25 percent for tax-exempt employers) of the employer's contributions to the premium. For 2014 and later years, the maximum credit percentage is 50 percent (35 percent for tax-exempts). For taxable years 2010 through 2013 eligible employer contributions were limited by the amount the employer would have contributed under the State average premium. For taxable years beginning after 2013, eligible employer contributions are limited by the average premium for the small group market in the rating area in which the employee enrolls for coverage. For example if the average premium in an employee's rating area was \$5,000, an employer paying for 60 percent of a single plan costing \$5,500 per year could claim no more than 60 percent of \$5,000 in qualified employer contributions for purposes of calculating the credit.

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

### **Reasons for Change**

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

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

### **Proposal**

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

The proposal would be effective for taxable years beginning after December 31, 2014.

# **INCENTIVES FOR MANUFACTURING, RESEARCH, AND CLEAN ENERGY**

## **ENHANCE AND MAKE PERMANENT RESEARCH INCENTIVES**

### **Current Law**

The research and experimentation (R&E) tax credit calculated under the “traditional” method equals 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer’s “fixed base percentage” and the average of the taxpayer’s gross receipts for the four preceding years. The taxpayer’s fixed base percentage generally is the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer’s qualified research expenses for the taxable year. Taxpayers can elect the alternative simplified research credit (ASC), which is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. Under the ASC, the rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the ASC applies to all succeeding taxable years unless revoked with the consent of the Secretary.

Qualified research expenses include both in-house research expenses and contract research expenses. Generally only 65 percent of payments for qualified research by the taxpayer to an outside person is included as contract research expenses, except that in the case of payments to a qualified research consortium, 75 percent of the payments is included.

The R&E tax credit is a component of the general business credit and is not allowed to offset alternative minimum tax (AMT) liability. In addition, there is a special rule for owners of a pass-through entity (section 41(g)), which limits the amount of credit to the amount of tax attributable to that portion of a person’s taxable income which is allocable or apportionable to the person’s interest in such trade or business or entity.

For certain research activities, the R&E tax credit allows a separate credit calculation equal to 20 percent of: (1) basic research payments above a base amount; and (2) all eligible payments to an energy research consortium for energy research.

The R&E tax credit expired on December 31, 2014.

Taxpayers may generally deduct R&E costs in the taxable year in which they are paid or incurred. However, business owners of pass-through entities who do not materially participate in the conduct of the trade or business must capitalize and amortize R&E costs over 10 years when calculating AMT for individuals.

### **Reasons for Change**

The R&E tax credit encourages technological developments that are an important component of economic growth. However, uncertainty about the future availability of the R&E tax credit

diminishes the incentive effect of the credit because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. To improve the credit's effectiveness, the R&E tax credit should be made permanent.

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

Smaller start-up businesses often face difficulties receiving outside financing to fund operations while new products are being developed. Allowing the R&E credit to offset AMT liability and repealing the current law restriction on use of the credit for pass-through business owners would enhance the ability of such businesses to benefit from the credit and encourage the growth of small, innovative businesses. Increasing the allowable percentage of contract research expenditures for qualified non-profit organizations would provide a greater incentive for these institutions to conduct research.

### **Proposal**

The proposal would make the R&E tax credit permanent for expenditures paid or incurred after December 31, 2014, with the exception of the traditional method, which would not apply for expenditures paid or incurred after December 31, 2015. In addition, for expenditures paid or incurred after December 31, 2015, the following changes would apply: (1) the rate of the ASC would increase from 14 percent to 18 percent; (2) the reduced ASC rate of six percent for businesses without qualified research expenses in the prior three years would be eliminated; (3) the credit would be allowed to offset AMT liability; (4) contract research expenses would include 75 percent of payments to qualified non-profit organizations (such as educational institutions) for qualified research; and (5) the special rule for owners of a pass-through entity would be repealed.

In addition, the proposal would repeal the requirement that R&E costs be amortized over 10 years when calculating individual AMT.

This proposal would apply to expenditures paid or incurred after December 31, 2015.

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

### **Current Law**

The work opportunity tax credit (WOTC) and the Indian employment credit provide temporary tax incentives to employers of individuals from certain targeted groups. Each credit is a component of the general business credit. The WOTC does not apply to an individual who begins work after December 31, 2014. The Indian employment credit does not apply for tax years beginning after December 31, 2014.

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

The WOTC is equal to 40 percent (25 percent for employment of 400 hours or less) of qualified wages paid during the first year of employment with a business (i.e., first-year wages). Qualified first-year wages are capped at the first \$3,000 for summer youth employees, \$10,000 for long-term family assistance recipients, \$12,000 for disabled veterans hired within one year of being discharged or released from active duty, \$14,000 for long-term unemployed veterans, \$24,000 for long-term unemployed veterans who are also disabled, and \$6,000 for all other categories of targeted individuals. In addition, the first \$10,000 of qualified second-year wages paid to long-term family assistance recipients is eligible for a 50-percent credit. A disabled veteran is a veteran entitled to compensation for a service-connected disability.

Qualified wages are those wages subject to the Federal Unemployment Tax Act, without regard to any dollar limitation in section 3306(b), paid by the employer to a member of a targeted group. Individuals must be certified by a designated local agency as a member of a targeted group. The WOTC does not apply to wages paid to individuals who work fewer than 120 hours in the first year of service. The employer's deduction for wages is reduced by the amount of the credit. The WOTC may fully offset alternative minimum tax liability.

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

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

wages and costs paid or incurred by the employer in calendar year 1993. Qualified wages and health insurance costs with respect to any employee for the taxable year may not exceed \$20,000. The employer's deduction for wages is reduced by the amount of the credit. Qualified wages do not include any wages taken into account in determining the WOTC.

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

### **Reasons for Change**

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

Disabled veterans may pursue educational and other training opportunities after release or discharge from military service before entering the civilian workforce, yet few who pursue such education or training would be likely to complete it within the one-year period in which they would remain qualified for the WOTC under current law. The Administration believes that such education and training is beneficial and that disabled veterans who pursue such opportunities should remain a qualified veteran for the purpose of the WOTC until six months after the education or training is completed.

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

### **Proposal**

The proposal would permanently extend the WOTC to apply to wages paid to qualified individuals who begin work for the employer after December 31, 2014.

In addition, for individuals who begin work for the employer after December 31, 2015, the definition of a qualified veteran would be expanded. Qualified veterans would now include disabled veterans who use G.I. Bill benefits to attend a qualified educational institution or training program within one year of being discharged or released from active duty, and are hired within six months of ending attendance at the qualified educational institution or training



program. Qualified first-year wages of up to \$12,000 paid to such individuals would be eligible for the WOTC.

The proposal would permanently extend the Indian employment credit to apply to wages paid to qualified employees in taxable years beginning after December 31, 2014.

In addition, the proposal would modify the calculation of the credit. For taxable years beginning after December 31, 2015, the credit would be equal to 20 percent of the excess of qualified wages and health insurance costs paid or incurred by an employer in the current taxable year over the amount of such wages and costs paid or incurred by the employer in the base year. The base year costs would equal the average of such wages and costs for the two taxable years prior to the current taxable year.

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

### **Current Law**

The general business tax credit includes a renewable electricity production tax credit, which is a credit per kilowatt hour of electricity produced from qualified energy facilities. Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. The electricity must be sold to an unrelated third party and a taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. Construction of a qualified facility must have begun before the end of 2014 for the facility to be eligible for the renewable electricity production tax credit.

The electricity production credit is indexed annually for inflation measured after 1992, based on the base amounts of 1.5 cents per kilowatt hour of electricity produced from wind, closed-loop biomass, geothermal energy, and solar energy and 0.75 cents per kilowatt hour for electricity produced in open-loop biomass, small irrigation power, landfill gas, trash, qualified hydropower, and marine and hydrokinetic renewable energy facilities. In 2014, the credit was 2.3 cents per kilowatt hour for qualified resources in the first group and 1.1 cents per kilowatt hour for qualified resources in the second group.

For all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. In the case of closed-loop biomass facilities modified to co-fire with coal and/or other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

The general business tax credit includes an investment tax credit for certain energy property. The investment credit is 30 percent of eligible basis for solar, fuel cell and small wind property placed in service by December 31, 2016, and 10 percent for microturbine and combined heat and power system property and geothermal property. For solar and non-heat pump geothermal property placed in service after 2016, a 10-percent credit is available.

### **Reasons for Change**

Production of renewable electricity and investment in property qualifying for the investment tax credit for energy property furthers the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and reducing greenhouse gas emissions. The extension of incentives for production and investment contributes to the continued success of that policy. In addition, many renewable developers have insufficient income tax liability to claim the renewable electricity production tax credits and must enter into joint ventures or other financing transactions with other firms to take advantage of them. Making the production tax credit refundable would reduce transaction costs, thereby increasing the incentives for firms to produce

clean renewable energy. Extending this policy permanently will provide certainty for business planning. Furthermore, some renewable electricity is consumed directly by the facility that owns the energy property and is not sold to an unrelated third party. Allowing such directly consumed electricity, when its production can be independently verified, to be eligible for the credit will increase the incentives for businesses to produce clean renewable energy.

### **Proposal**

The proposal would extend prior law for facilities on which construction begins before the end of 2015. For facilities on which construction begins after December 31, 2015, the proposal would permanently extend the renewable electricity production tax credit and make it refundable. In addition, the proposal would make the production tax credit available to otherwise eligible renewable electricity consumed directly by the producer rather than sold to an unrelated third party to the extent that its production can be independently verified. Solar facilities that qualify for the investment tax credit would be eligible for the renewable electricity production tax credit for construction that begins after December 31, 2015. The proposal would also allow individuals to claim the production tax credit for residential energy efficient property installed on a dwelling unit. The current credit for energy efficient property would be allowed to expire at the end of 2016.

The proposal would also permanently extend the investment tax credit under the terms available to sources in 2016. Specifically, the proposal would permanently extend the 30-percent investment tax credit for solar, fuel cell, and small wind property and the 10-percent credit for geothermal, microturbine, and combined heat and power property. The proposal would also make permanent the election to claim the investment tax credit in lieu of the renewable electricity production tax credit for qualified facilities eligible for the production tax credit.

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

### **Current Law**

Taxpayers are allowed to deduct expenditures for energy efficient commercial building property placed in service on or before December 31, 2014. Energy efficient commercial building property is defined as property (1) installed on or in any building that is located in the United States and is within the scope of Standard 90.1-2001, (2) installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, (3) certified as being installed as part of a plan designed to reduce the total annual energy use with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building that meets the minimum requirements of Standard 90.1-2001, and (4) with respect to which depreciation (or amortization in lieu of depreciation) is allowable. Standard 90.1-2001, as referred to here, is Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (ASHRAE/IESNA) as in effect on April 2, 2003 – a nationally accepted building energy code that has been adopted by State and local jurisdictions throughout the United States; new editions of the standard are reviewed by the Department of Energy under section 304 of the Energy Conservation and Production Act. The maximum allowable deduction with respect to a building for all tax years is limited to \$1.80 per square foot.

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

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

### **Reasons for Change**

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

## **Proposal**

The proposal would extend the current law for property placed in service before January 1, 2016 and update it to apply Standard 90.1-2004. For facilities placed in service after December 31, 2015, the proposal would permanently extend and modify the current deduction with a larger fixed deduction. The deduction would be \$3.00 per square foot for improvements that are part of a certified plan designed to reduce energy use by the building as a whole by at least 50 percent, relative to a reference building that meets the minimum requirements of Standard 90.1-2004. For improvements that are part of a certified plan to reduce energy use by one of the separate building systems by a proportion that would lead to at least 50-percent savings if applied to the building as a whole, the deduction would be \$1.00 per square foot. For taxpayers that simultaneously satisfy the energy savings targets for both the building envelope and heating, cooling, ventilation, and hot water systems, the deduction would be \$2.00. Energy-savings reference standards would be updated every three years by the Secretary in consultation with the Secretary of Energy to encourage innovation by the commercial building industry.

The proposal would also provide a new deduction based on projected energy savings achieved by the retrofitting of existing commercial buildings. Deduction amounts and energy-savings targets would be the same as for new commercial buildings but the building's projected energy savings would be measured relative to a specified energy-use baseline. The deduction would only apply to existing buildings with at least 10 years of occupancy. Projections of energy savings and specification of the comparison energy-use baselines for existing buildings would be based on methods and procedures provided by the Secretary in consultation with the Secretary of Energy.

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

The deduction would be available for certified improvements made after December 31, 2015.

## **PROVIDE A CARBON DIOXIDE INVESTMENT AND SEQUESTRATION TAX CREDIT**

### **Current Law**

Current law allows a carbon dioxide sequestration credit of \$20 per metric ton of qualified carbon dioxide that is captured at a qualified facility and disposed of in secure geological storage and not used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project, and \$10 per metric ton if used as a tertiary injectant in an enhanced oil or natural gas recovery. The credit is indexed annually by an inflation adjustment factor. The credit is allowed through the end of the calendar year in which the Secretary certifies that 75 million metric tons of qualified carbon dioxide have been sequestered.

### **Reasons for Change**

Carbon dioxide sequestration will reduce greenhouse gas emissions from fossil fuel combustion. The current sequestration credit does not provide incentives for carbon dioxide sequestration beyond the current phase-out quantity. Investments in carbon dioxide capture and sequestration technologies will help facilitate additional technological improvements that will be important for reducing the costs of controlling future greenhouse gas emissions.

### **Proposal**

The proposal would authorize \$2 billion to be allocated as a new refundable investment tax credit. Credits would be available to new and retrofitted electric generating units. New plants would be required to capture more than 75 percent of their carbon dioxide (CO<sub>2</sub>) emissions. Retrofits would be required to capture more than 75 percent of the CO<sub>2</sub> emissions from the set of units to which the eligible investment is applied. Retrofits would be required to apply to existing plant units that have capacities greater than 250 megawatts and that capture and store more than one million metric tons CO<sub>2</sub> per year.

The investment tax credit would be available for 30 percent of the installed cost of eligible property. Eligible property would include CO<sub>2</sub> transportation and storage infrastructure, including pipelines, wells, and monitoring systems. Applications for the investment credit would be due 18 months after enactment, after which date the Secretary would determine the amount of credit awarded to each applicant. Taxpayers would be able to apply an investment tax credit to part of or all of the qualified investment in the project. In determining the award of the investment tax credit, the Secretary would consider (i) the credit per ton of net sequestration capability and (ii) the expected contribution of the technology and the type of plant to which that technology is applied to the long-run economic viability of carbon sequestration from fossil fuel combustion. No more than 60 percent of the total credits would be allowed to flow either to new projects or to retrofits. In addition, no more than 40 percent of the total credits would be allowed to flow to any one of the following technology categories: (i) liquid solvents, (ii) solid sorbents, (iii) gas-separation membranes, (iv) warm gas clean-up, (v) oxygen fired combustion systems, and (vi) hybrid systems. A minimum of 70 percent of the credits would be required to flow to projects fueled by greater than 75 percent coal.

The proposal would also allow a new refundable sequestration tax credit for qualified investments at a rate of (1) \$50 per metric ton of CO<sub>2</sub> permanently sequestered and not beneficially reused (e.g., in an enhanced oil recovery operation) and (2) \$10 per metric ton for CO<sub>2</sub> that is permanently sequestered and beneficially reused. The credit would be indexed for inflation and would be allowed for a maximum of 20 years of production.

The proposal would be effective after the date of enactment.

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

### **Current Law**

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

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

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

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

### **Reasons for Change**

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



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

The lack of a reliable and extensive network of refueling stations can inhibit the adoption of alternative fuel vehicles. Using some of the credit allocation to subsidize construction of such networks (or other related infrastructure) would promote the use of cleaner burning alternative fuels.

### **Proposal**

The proposal would authorize an additional \$2.5 billion of credits for investments in eligible property used in a qualifying advanced energy manufacturing project. Up to \$200 million of these credits may be allocated to the construction of infrastructure that contributes to networks of refueling stations that serve alternative fuel vehicles. Taxpayers would be able to apply for a credit with respect to part or all of their qualified investment. If a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government would be taken into account in determining whether to allocate credits to the project.

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

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

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would provide about \$2 billion in credits for qualified investments approved in each of the three years, 2016 through 2018.

## **EXTEND THE TAX CREDIT FOR SECOND GENERATION BIOFUEL PRODUCTION**

### **Current Law**

In 2013, the “cellulosic biofuel producer credit” was renamed the “second generation biofuel producer credit”. It expired on December 31, 2014. This nonrefundable income tax credit of \$1.01 was available for each gallon of qualified second generation biofuel produced in a taxable year. Second generation biofuel includes any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived from fibre-based sources (lignocellulosic or hemicellulosic matter) available on a renewable or recurring basis or from cultivated algae or related microorganisms, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (EPA) under section 211 of the Clean Air Act. Thus, to qualify for the credit the fuel must be approved by the EPA. Second generation biofuel cannot qualify as biodiesel, renewable diesel, or alternative fuel for purposes of the income tax credit, excise tax credit, or payment provisions relating to those fuels.

### **Reasons for Change**

Second generation biofuels have the potential to reduce petroleum consumption and greenhouse gas emissions. Extending the existing tax credit would support this transformative transportation fuel. However, support for this fuel should be phased out in the future as this fuel becomes cost-competitive.

### **Proposal**

The proposal would retroactively extend the tax credit for blending cellulosic fuel at \$1.01 per gallon through December 31, 2020, and would then reduce the amount of the credit by 20.2 cents per gallon in each subsequent year, so that the credit would expire after December 31, 2024.

## **INCENTIVES TO PROMOTE REGIONAL GROWTH**

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

#### **Current Law**

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

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

The NMTC expired on December 31, 2014.

#### **Reasons for Change**

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

#### **Proposal**

The proposal would extend the NMTC permanently, with an allocation amount of \$5 billion for each year. The proposal also would permit NMTC amounts resulting from QEIs made after December 31, 2014, to offset AMT liability.

The proposal would be effective upon enactment.

## **REFORM AND EXPAND THE LOW-INCOME HOUSING TAX CREDIT (LIHTC)**

### **Current Law**

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

### **Computation of the credit amount**

For a building to qualify for LIHTCs, a minimum portion of the units in the building must be rentrestricted and occupied by low-income tenants. Under section 42(g)(1) of the Code, the taxpayer makes an irrevocable election between two criteria. Either:

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

In all cases, qualifying income standards are adjusted for family size. Maximum allowable rents are restricted to 30 percent of the elected income standard, adjusted for the number of bedrooms in the unit.

The amount of the investment used in the credit calculation (the “qualified basis”) is the product of the portion of the building attributable to low-income units times the building’s “eligible basis” (generally, depreciable basis at the end of the first taxable year in the credit period). In some cases, however, to enhance the economic feasibility of a project, the Code increases eligible basis by 30 percent (thus increasing the owner’s LIHTCs by 30 percent) (a “basis boost”).

For example, a basis boost applies to buildings in Qualified Census Tracts (QCTs). A QCT is a census tract that is characterized by a specified poverty rate or by a specified concentration of low-income residents and that is designated as a QCT by the Department of Housing and Urban Development (HUD). These designations, however, may not be made for a combination of census tracts in a metropolitan statistical area (MSA) if the aggregate population of the combination of tracts exceeds 20 percent of population of the MSA.

There are two applicable percentages, referred to as the 70-percent present value credit rate and the 30-percent present value credit rate. Each month, the IRS announces these rates. The stated goal is rates such that the 10 annual installments of the credit have a present value of 70 percent (or 30 percent) of the total qualified basis of the property. The Code prescribes a risk-free discount factor and other computational assumptions that the IRS must use in setting the rates.

The Housing and Economic Recovery Act of 2008 provided a temporary minimum applicable percentage of nine percent for the 70-percent present value credit rate for buildings placed in service after July 30, 2008, and before December 31, 2013. The American Taxpayer Relief Act of 2012 extended the nine-percent rate to apply to credit allocations made before January 1, 2014. The Tax Increase Prevention Act of 2014 extended this minimum applicable percentage to allocations made before January 1, 2015.

#### Additional prerequisites for earning LIHTCs

Credits are not available unless occupancy is available to the general public. Section 42(g)(9), however, clarifies that a project does not fail to meet this general public use requirement solely because of occupancy restrictions or preferences that favor tenants with special needs, tenants who are members of a specified group under certain Federal or State programs, or tenants who are involved in artistic or literary activities.

To ensure that low-income buildings remain low-income buildings for decades, no LIHTCs are allowed with respect to any building for any taxable year unless an extended low-income housing commitment (Long-Term-Use Agreement, or Agreement) is in effect as of the end of the year. A Long-Term-Use Agreement is a contract between the owner of the property and the applicable State housing credit agency (Agency). The Agreement must run with the land to bind future owners of the property for three decades or more, and certain provisions of the Agreement must be enforceable in State court not only by the Agency but also by any past, present, or future income-qualified tenant. In addition to requiring that certain minimum portions of a building be low-income units, the Long-Term-Use Agreement must mandate certain conduct in the management of the building, including prohibiting the refusal to lease because the prospective tenant is a holder of a voucher or certificate of eligibility under section 8 of the United States Housing Act of 1937 and prohibiting eviction (other than for good cause) of any existing tenant in a low-income unit.

#### The allocation process

Every year, the Code provides each State with a limited number of LIHTCs that the State may allocate among proposed projects that are designed to earn LIHTCs. In general, regardless of how large a building's qualified basis may be, the LIHTCs that the owner may earn from the building are limited by the amount that the State has allocated. Each State (including any Agencies) must adopt a qualified allocation plan (QAP) to guide the allocation.

A QAP must give preference to projects serving the lowest income tenants, to projects obligated to serve qualified tenants for the longest periods, and to projects which are located in QCTs and the development of which contributes to a concerted community revitalization plan. In addition, the Code prescribes ten selection criteria that every QAP must include—project location, housing needs characteristics, project characteristics (including whether the project includes the use of existing housing as part of a community revitalization plan), sponsor characteristics, tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project. A QAP must also provide a procedure that

the Agency (or its agent) will follow in monitoring for noncompliance with the rules for LIHTC eligibility and in notifying the IRS of any noncompliance of which the Agency has become aware.

### Private activity bonds

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

In addition to earning LIHTCs as a result of receiving a State allocation of LIHTCs, a building owner can generate LIHTCs by financing the building with qualified PABs. Without any State allocation, LIHTCs may be earned on the full qualified basis of a building if the qualified PABs finance at least half of the aggregate basis of the building and the land. In the case of these bond-derived credits, however, the credit rate is the 30-percent present value credit rate, not the 70-percent present value credit rate (or, when applicable, at the 9-percent minimum rate), which generally applies to State-allocated credits. Bond-derived credits do not reduce the State’s remaining allocable LIHTCs.

### Protection against domestic abuse

LIHTCs support the construction and preservation of a large portion of the nation’s affordable housing for people of limited means. LIHTCs differ, however, from Federal housing programs in its combination of the following attributes: the housing itself is owned and managed by private-sector persons, these persons are answerable in the first instance to State authorities (which are responsible for monitoring compliance with Federal requirements), and the Federal role (undertaken by the IRS) is to determine whether the owners are entitled to tax credits.

Section 601 of the Violence Against Women Reauthorization Act of 2013 provides that applicants or tenants of certain federally assisted housing may not be denied admission to, denied assistance under, terminated from participation in, or evicted from, the housing on the basis that the applicant or tenant is or has been a victim of domestic violence, dating violence, sexual assault, or stalking (collectively, “domestic abuse”). In appropriate cases, a lease may be bifurcated to evict or otherwise remove the perpetrator of criminal domestic abuse and yet to avoid penalizing a victim of that abuse who is a lawful occupant. That section applies these duties to “the low income housing tax credit program under section 42 of the Internal Revenue Code of 1986.”

### Reasons for Change

Agencies in charge of allocating LIHTCs are often confronted with a larger number of deserving projects than they can support. Some of these buildings can be built only with higher credit rate LIHTCs. Increasing the volume of higher rate credits would allow the development of some

projects for which the current supply is insufficient. In addition, some developers obtain LIHTCs by financing their buildings with PABs even though they have access to more preferred financing options. The resulting transaction costs consume resources that might otherwise provide affordable housing.

In practice, the income criteria often produce buildings that serve a narrow income band of tenants—those just below the eligible income threshold. Without incentives to create mixed-income housing, LIHTC-supported buildings may not serve those most in need. In addition, the inflexibility of the income criteria makes it difficult for LIHTC to support acquisition of partially or fully occupied properties for preservation or repurposing.

The current discounting formula does not function well when interest rates are particularly high or low. When interest rates are very low, States may be unable to address their highest affordable-housing priorities, which often require high levels of LIHTC subsidy. The recent reductions in the Federal and State resources that might have filled financing gaps exacerbate the difficulty posed by the too-low discount rate. The temporary nine-percent floor was a response to these challenges. In high-interest-rate environments, the need for LIHTCs is especially acute. Rising interest rates increase the gap between an owner's expenditures and the restricted rents that the LIHTC statute allows the owner to collect.

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

Because of the population cap on census tracts in an MSA that may be designated as QCTs, some tracts with qualifying levels of poverty or low income residents may be kept from QCT status by the presence of similarly distressed areas in the same MSA. Nearby poverty should not bar an otherwise-eligible poor census tract from qualifying for increased subsidies.

Although the Violence Against Women Reauthorization Act of 2013 provides that no building that has produced LIHTCs for its owner should fail to provide reasonable protections for victims of domestic abuse, it does not amend the Code, nor does it contain any provision for enforcing those protections in LIHTC buildings.

## **Proposal**

### Allow conversion of private activity bond volume cap into LIHTCs

The proposal would provide two ways in which PAB volume cap could be converted into LIHTCs.

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



For each \$1,000 of PAB volume cap surrendered, the State would receive additional allocable LIHTCs for the calendar year equal to:  $\$1000 \times$  twice the applicable percentage that applies for PAB-financed buildings and that is determined under section 42(b)(1)(B)(ii) for December of the preceding calendar year.

The aggregate amount of PAB volume cap that each State may convert with respect to a calendar year is 18 percent of the PAB volume cap that the State receives for that year under section 146(d)(1).

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

Second, instead of obtaining the lower-rate credits by financing at least 50 percent of a building with PABs, a taxpayer could obtain these credits by satisfying the following requirements: (1) there is an allocation of PAB volume cap in an amount not less than the amount of bonds that would be necessary to qualify for LIHTCs and (2) the volume cap so allocated reduces the State's remaining volume cap as if tax-exempt bonds had been issued.

The proposal would be effective for projects that are allocated volume cap after the date of enactment.

#### Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income

The proposal would add a third criterion to the two section 42(g)(1) criteria that are described above. When a taxpayer elects this third criterion, at least 40 percent of the units in the project would have to be occupied by tenants with incomes that average no more than 60 percent of AMI. No rent-restricted unit, however, could be occupied by a tenant with income over 80 percent of AMI; and, for purposes of computing the average, any unit with an income limit that is less than 20 percent of AMI would be treated as having a 20-percent limit. Maximum allowable rents would be determined according to the income limit of the unit. A project would satisfy the third criterion only if the average income of the units is no more than 60 percent of AMI both (1) calculated with all low-income units weighted equally; and (2) calculated with each low-income unit weighted according to imputed LIHTC occupancy rules, i.e., 1.5 occupants per bedroom and one occupant for zero-bedroom units).

For example, suppose that a project has 70 identical rent-restricted units—10 units with income limits of 20 percent of AMI, 10 with limits of 40 percent of AMI, 20 with limits of 60 percent of AMI, and 30 with limits of 80 percent of AMI. This would satisfy the new criterion because none of the limits exceeds 80 percent of AMI and the average does not exceed 60 percent of AMI. ( $10 \times 20 + 10 \times 40 + 20 \times 60 + 30 \times 80 = 4200$ , and  $4200/70 = 60$ .) (Because all of the units are identical, when the average is calculated weighting each unit by its imputed occupancy, the weighted average is also 60.)

A special rule would apply to rehabilitation projects that contain units that receive ongoing subsidies (e.g., rental assistance, operating subsidies, and interest subsidies) administered by HUD or the Department of Agriculture. If a tenant, when admitted to such a property, had an income not more than 60 percent of the then-applicable AMI and if, when the tenant's income is measured for purposes of LIHTC qualification, the tenant's income is greater than 60 percent of the now-applicable AMI but not more than 80 percent of AMI (this fraction is called the "Credit-Year-1 AMI Percentage"), then, the taxpayer may make an election that would allow the tenant to remain in residence without impairing the building's LIHTCs. In particular, the election would have the following consequences: (1) the average-income calculations would be made without taking that tenant's unit into account; (2) the requirement in the next-available-unit rule, *see* section 42(g)(2)(D)(ii), would apply; and (3) the tenant's unit would be treated as rent-restricted if the gross rent collected from the unit does not exceed 30 percent of the Credit-Year-1 AMI Percentage multiplied by the current AMI.

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

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

#### Change formulas for 70 percent PV and 30 percent PV LIHTCs

The proposal would not extend the nine-percent temporary minimum applicable percentage, which expired at the end of 2014, but it would increase the discount rate used in the present value calculation for the credit rates used for allocated LIHTCs. The change would apply to both the 70-percent present value applicable percentage and to the 30-percent present value applicable percentage, but only with respect to allocated LIHTCs. The new discount rate would better reflect private-market discount rates. Under the proposal, the discount rate to be used would be the average of the mid-term and long-term applicable Federal rates for the relevant month, plus 200 basis points. (The 30-percent present value applicable percentage for LIHTCs that result from tax-exempt bond financing would continue to be computed under current law.)

The proposal would be effective for buildings that receive allocations on or after the date of enactment.

#### Add preservation of federally assisted affordable housing to allocation criteria

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

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

### Remove the QCT population cap

The proposal would allow HUD to designate as a QCT any census tract that meets the current statutory criteria of a poverty rate of at least 25 percent or 50 percent or more of households with an income less than 60 percent of AML. That is, the proposal would remove the current limit under which the aggregate population in census tracts designated as QCTs cannot exceed 20 percent of the metropolitan area's population.

This change would apply to buildings that receive allocations of LIHTCs or volume cap after the date of enactment.

### Implement requirement that LIHTC-supported housing protect victims of domestic abuse

Protections for victims of domestic abuse would be required in all Long-Term-Use Agreements. These provisions would apply to both the low-income and the market-rate units in the building. For example, once such an Agreement applies to a building, the owner could not refuse to rent any unit in the building to a person because that person had experienced domestic abuse. Moreover, such an experience of domestic abuse would not be good cause for terminating a tenant's occupancy. Under the Agreement, an owner could bifurcate a lease so that the owner could simultaneously (1) remove or evict a tenant or lawful occupant who engaged in criminal activity directly relating to domestic abuse and (2) avoid evicting, terminating, or otherwise penalizing a tenant or lawful occupant who is a victim of that criminal activity. The proposal would clarify that such a continuing occupant of a low-income unit could become a tenant and would not have to be tested for low-income status as if the continuing occupant were a new tenant.

Any prospective, present, or former occupant of the building could enforce these provisions of an Agreement in any State court, whether or not that occupant meets the income limitations applicable to the building.

In addition, the proposal would clarify that occupancy restrictions or preferences that favor persons who have experienced domestic abuse would qualify for the "special needs" exception to the general public use requirement.

The proposed requirements for Long-Term-Use Agreements would be effective for Agreements that are either first executed, or subsequently modified, 30 days or more after enactment. The proposed clarification of the general public use requirement would be effective for taxable years ending after the date of enactment.

## **INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE**

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

#### **Current Law**

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

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

#### **Reasons for Change**

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

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

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

Pursuant to the requirements of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, refund payments to State and local government issuers claiming refundable tax credits for their Build America Bonds currently are being reduced by a sequestration rate. For refund payments processed by the IRS on or after October 1, 2014 and on or before September 30, 2015, the refundable tax credit payments to issuers are reduced by the fiscal year 2015 sequestration rate of 7.3 percent. Market participants have argued that current sequestration cuts to refundable tax credit payments for Build America Bonds has reduced investor interest in purchasing these types of taxable bonds.

America Fast Forward Bonds would build upon the successful example of the Build America Bond program by providing a new bond program with broader uses that will attract new sources of capital for infrastructure investment (e.g., pension funds may be investors in America Fast Forward Bonds, though they typically do not invest in tax-exempt bonds). In order to alleviate concerns about future sequestration cuts, refundable tax credit payments to issuers of America Fast Forward Bonds, should be protected from sequestration.

### **Proposal**

#### **Provide America Fast Forward Bonds and expand eligible uses**

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

Eligible uses for America Fast Forward Bonds would include: (1) original financing for governmental capital projects, as under the authorization of Build America Bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid promptly within 90 days of issuance of the current refunding bonds; (3) short-

term governmental working capital financings for governmental operating expenses (such as tax and revenue anticipation borrowings for seasonal cash flow deficits), subject to a 13-month maturity limitation; and (4) financing for section 501(c)(3) nonprofit entities.

The proposal also recommends precluding direct payments to State and local government issuers under the permanent America Fast Forward Bond program from being subject to sequestration. For purposes of this proposal, the term “sequestration” means any reduction in direct spending pursuant to the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, the Statutory-Pay-As-You-Go Act of 2010, as amended or the Budget Control Act of 2011, as amended.

Allow eligible use of America Fast Forward Bonds to include financing all qualified private activity bond program categories

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. Further, eligible uses would include financing for projects that can be financed with the new type of qualified private activity bond known as “Qualified Public Infrastructure Bonds” that is included in the Budget.

The proposal would be effective for bonds issued on or after January 1, 2016.

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

### **Current Law**

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

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

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

### **Reasons for Change**

Tax policy favors current refundings of State and local bonds within appropriate size and maturity parameters because these current refundings generally reduce both: (1) borrowing costs for State and local governmental issuers; and (2) Federal revenue costs or tax expenditure costs of Federal subsidies for borrowing costs on State and local bonds. The primary reason that States and local governments engage in current refunding transactions is to reduce interest costs.<sup>1</sup>

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<sup>1</sup> By comparison, an “advance refunding” refers to a refinancing in which the refunding bonds and the prior bonds may remain outstanding concurrently for more than 90 days. Advance refundings involve duplicative Federal subsidy costs for the same financed project or purpose. Section 149(d) restricts advance refundings.

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

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

### **Proposal**

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

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

This provision would apply generally to State and local bond programs or provisions that do not otherwise allow current refundings or expressly address the treatment of current refundings (including bonds for which bond volume caps or time deadlines applied to issuance of original bonds). This provision would be inapplicable to State and local bond programs or provisions that otherwise allow or expressly address current refundings, such as traditional tax-exempt governmental bonds under section 103 for which current refundings generally are allowable without statutory bond maturity restrictions and qualified tax-exempt private activity bonds under section 141(e) for which current refundings generally are allowable within prescribed statutory bond maturity restrictions under section 147(b).

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



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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

### **Current Law**

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

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

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

### **Reasons for Change**

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

### **Proposal**

The proposal would increase the \$15 billion aggregate amount permitted to be allocated by the Secretary of Transportation to \$19 billion with the elimination of this category of bond and conversion to qualified public infrastructure bonds once these funds are allocated.

The proposal would be effective upon enactment.

## **PROVIDE A NEW CATEGORY OF QUALIFIED PRIVATE ACTIVITY BONDS FOR INFRASTRUCTURE PROJECTS REFERRED TO AS “QUALIFIED PUBLIC INFRASTRUCTURE BONDS”**

### **Current Law**

State and local governments are eligible to issue tax-exempt bonds to finance a wide range of public infrastructure projects. There are two basic kinds of tax-exempt bonds: governmental bonds and qualified private activity bonds. In general, the interest on tax-exempt bonds is excludable from the gross income of the owners.

Bonds generally are treated as governmental bonds if the bond proceeds are used predominantly for State or local governmental use or the bonds are secured or payable predominantly from State or local governmental sources of payment. Governmental bonds are subject to various general restrictions, including private business limitations, private loan limitations, arbitrage investment restrictions, registration and reporting requirements, Federal guarantee restrictions, advance refunding limitations, spending period limitations, and pooled bond limitations.

Private activity bonds may be issued on a tax-exempt basis to finance different specified types of eligible exempt facilities and programs if they meet the general requirements for governmental bonds (except for the private business limitations) and additional requirements for qualified private activity bonds, including a bond volume cap for most private activity bonds. Qualified private activity bonds include exempt facility bonds, qualified mortgage bonds, qualified small issue bonds, qualified student loan bonds, qualified redevelopment bonds, and qualified section 501(c)(3) bonds. Eligible facilities that may be financed with exempt facility bonds include, among others, airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities, and qualified highway or surface freight transfer facilities. In addition, for qualified private activity bonds used to finance airports, docks and wharves, mass commuting facilities, and environmental enhancements of hydro-electric generating facilities, a governmental ownership requirement applies. Exempt facilities also must meet a “public use” requirement by serving a general public use or being available for general public use. An AMT preference applies to the interest on specified private activity bonds, including most private activity bonds.

### **Reasons for Change**

The Administration recognizes the importance of public infrastructure investment and the role that the private sector can play in public infrastructure projects. The existing framework for tax-exempt bonds limits private sector involvement in public infrastructure projects in various respects. For governmental bonds, the strict private business limitations limit private sector involvement. For qualified private activity bonds, in certain circumstances, the bond volume cap requirement may constrain private sector commitments to larger scale and longer term public infrastructure projects for which sufficient volume cap may be unavailable or uncertain. The proposal aims to encourage greater private investment in public infrastructure through a new hybrid category of tax-exempt bonds. This new category would require core hallmarks of public

infrastructure through governmental ownership and general public use, but would remove the private business limitations, the bond volume cap requirement, and the AMT preference that may impede private investment. This new category would facilitate longer-term lease, management, operation, and concession arrangements than under the existing framework.

## **Proposal**

In general, the proposal would create a new category of tax-exempt qualified private activity bonds called “Qualified Public Infrastructure Bonds” (QPIBs) that would be eligible to finance the following specific categories of infrastructure projects that are permitted to be financed with exempt facility bonds under current law: (1) airports; (2) docks and wharves; (3) mass commuting facilities; (4) facilities for the furnishing of water; (5) sewage facilities; (6) solid waste disposal facilities; and (7) qualified highway or surface freight transfer facilities. To ensure the public nature of financed infrastructure, the proposal would impose two core eligibility requirements for QPIBs: a governmental ownership requirement and a public use requirement. The proposal would require that the projects financed by QPIBs must be owned by a State or local governmental unit. To enhance certainty, the proposal would provide a safe harbor for establishing governmental ownership of financed projects that would follow the same principles as the existing safe harbor under section 142(b)(1)(B) for governmental ownership of airports, docks and wharves, mass commuting facilities, and environmental enhancements of hydro-electric generative facilities that are financed with exempt facility bonds. In addition, the proposal would require that projects financed by QPIBs meet a public use requirement by serving a general public use or being available on a regular basis for general public use. Further, except as otherwise provided, the proposal would require that QPIBs meet the existing eligibility restrictions for qualified private activity bonds.

The proposal would make the bond volume cap requirement inapplicable to QPIBs. The proposal also would make the AMT preference for interest on specified private activity bonds inapplicable to QPIBs.

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

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

## **MODIFY QUALIFIED PRIVATE ACTIVITY BONDS FOR PUBLIC EDUCATIONAL FACILITIES**

### **Current Law**

State and local governments are eligible to issue tax-exempt governmental bonds for a wide range of public infrastructure projects and other projects if the bond proceeds are used predominately for State and local government use or the bonds are payable or secured predominately from State and local government sources of payments, such as generally applicable taxes. State and local governments are also eligible to issue tax-exempt private activity bonds with permitted private business use and other private involvement to finance certain specified types of projects. In general, the interest on tax-exempt bonds is excludable from the gross income of the owners.

Current law permits tax-exempt private activity bond financing for different specified types of eligible exempt facilities and programs, including, among others, “qualified public educational facilities” under section 142(k) of the Code that are part of public elementary or secondary schools. The current eligibility rules require that a private “corporation” own the public school facilities under a public-private partnership agreement with a public State or local educational agency and that the private corporation transfer the ownership of the school facilities to the public agency at the end of the term of the bonds for no additional consideration. In addition, a special separate annual volume cap (equal to the greater of \$10 multiplied by the State population or \$5 million) applies to these bonds.

### **Reasons for Change**

Certain program rules have impeded any significant use of tax-exempt bond financing for qualified public educational facilities. The requirement that only private “corporations” may own the school facilities has limited use by private owners that are organized as other kinds of private entities (such as partnerships, limited liability companies, or sole proprietors), or that operate the school facilities under arrangements without ownership. In addition, legal uncertainty has arisen over the apparent conflict between the private ownership requirement for the school facilities and the requirement that the private owner also transfer the school facilities to a public agency at the end of the term of the bonds for no additional consideration. Finally, the separate bond volume cap for these bonds adds complexity in comparison with the unified annual State bond volume cap for most categories of tax-exempt private activity bonds.

### **Proposal**

The proposal would eliminate the private corporation ownership requirement and instead would allow any private person, including private entities organized in ways other than as corporations, either to own the public school facilities or to operate those school facilities through lease, concession, or other operating arrangements. In addition, since private ownership would no longer be an eligibility condition, the proposal would remove the requirement to transfer the school facilities to a public agency at the end of the term of the bonds for no additional consideration. Finally, the proposal would remove the separate volume cap for qualified public

educational facilities and instead would include these facilities under the unified annual State bond volume cap for private activity bonds under section 146.

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

## **MODIFY TREATMENT OF BANKS INVESTING IN TAX-EXEMPT BONDS**

### **Current Law**

Generally, banks, thrift institutions, and other financial institutions may not deduct any portion of their interest expenses allocable to tax-exempt interest on obligations acquired after August 7, 1986. In general, the amount of interest that is disallowed is the amount that bears the same ratio to interest expense as the taxpayer's average adjusted basis in tax-exempt obligations bears to the average adjusted basis for all assets.

Financial institutions, however, can generally deduct 80 percent of their interest expenses allocable to tax-exempt interest on qualified tax-exempt obligations. Qualified tax-exempt obligations are certain tax-exempt obligations that are issued by qualified small issuers. Qualified small issuers are States and localities that issued no more than \$10 million of certain tax-exempt bonds annually (the qualified small issuer limit).

For tax-exempt bonds issued in 2009 and 2010, the American Recovery and Reinvestment Act of 2009 (ARRA) established a temporary rule that allowed financial institutions to deduct up to 80 percent of interest expense allocable to any tax-exempt bond issued in 2009 or 2010, regardless of whether the bond was a qualified tax-exempt obligation. However, the bonds that benefited from this temporary rule could not exceed two percent of the taxpayer financial institution's total assets. In addition, for obligations issued during 2009 and 2010, ARRA modified the definition of qualified small issuer to allow the annual issuance of up to \$30 million in these bonds. ARRA did not impose a limitation on the amount of qualified tax-exempt bonds that a financial institution could treat as such.

Although there is no legislative history suggesting that Congress intended for financial institutions that are S corporations or qualified subchapter S subsidiaries to be exempted from the 20-percent disallowance of interest expenses allocable to qualified tax-exempt obligations, litigation has led to this result. As a result, under current law these financial institutions deduct all interest expenses allocable to qualified tax-exempt obligations.

### **Reasons for Change**

The interest expense disallowance under current law deters banks, thrifts, and other financial institutions from investing in tax-exempt debt. The tax-exempt bond market is disproportionately retail in its investor base, and incentives for more institutional investment in this market may improve liquidity, particularly for smaller issuers who may have more challenges in accessing the market. Experience from 2009 and 2010 suggests that banks held more tax-exempt bonds as a result of ARRA's general loosening of the interest expense disallowance. These institutions' renewed absence from (or limited presence in) the market for tax-exempt debt may reduce the demand for this debt and raise the interest rates that State and local governments have to pay.

Moreover, the qualified small issuer limit has not been raised permanently since 1986. Raising it to \$30 million would compensate for the effects of inflation. Given that issuers between

\$10 million and \$30 million, like smaller issuers, also have difficulty borrowing, raising the limit to \$30 million would encourage banks to hold these issuers' obligations. Loosening the interest expense disallowance rules would encourage financial institutions to hold more tax-exempt bonds in order to improve the functioning of the tax-exempt bond market.

As compared to current law, subjecting financial institutions that are S corporations or qualified subchapter S subsidiaries to the 20-percent disallowance could discourage them from holding qualified tax-exempt obligations but would equalize their treatment with that of other financial institutions.

### **Proposal**

The proposal would permanently expand the qualified small issuer limit in the definition of qualified tax-exempt obligations to include issuers of up to \$30 million of tax-exempt bonds annually. As under ARRA, the amended qualified small issuer exception would not be limited to two percent of a taxpayer's assets. This increase would enable financial institutions to deduct 80 percent of interest expenses allocable to qualifying bonds of these issuers. In addition, beginning with bonds issued in 2016, the proposal would permanently implement the ARRA exception that allowed financial institutions to deduct up to 80 percent of interest expenses allocable to any tax-exempt bond, regardless of whether the bond is a qualified tax-exempt obligation. This exception would continue to be limited to two percent of the taxpayer's assets. The same rules that are applicable to C corporation financial institutions would also be applied to financial institutions that are S corporations or qualified subchapter S subsidiaries. Thus, the current, more generous no-disallowance rules available to these financial institutions would be repealed.

The proposal would apply to bonds issued in calendar years beginning on or after January 1, 2016.



## **REPEAL TAX-EXEMPT BOND FINANCING OF PROFESSIONAL SPORTS FACILITIES**

### **Current Law**

Gross income does not include interest on State or local tax-exempt bonds if the bonds meet certain eligibility requirements. State and local bonds are classified as either governmental bonds or private activity bonds. The exclusion from income for State and local bond interest does not apply to private activity bonds unless they are issued for certain permitted purposes and therefore qualify as “qualified private activity bonds.” Bonds generally are classified as private activity bonds under a two-part test if: (1) more than 10 percent of the bond proceeds are used for private business use (private business use test); and (2) the debt service on more than 10 percent of the bond proceeds is payable or secured from property or payments derived from private business use (private payments test). Thus, current law permits the use of tax-exempt governmental bond proceeds if either part of this test is not met.

Professional sports facilities, such as stadiums, cannot be financed with qualified private activity bonds because they are not one of the permitted categories. Even if use by a professional sports team of a bond-financed stadium exceeds 10 percent of the total use of the facility, the stadium nonetheless can be financed with tax-exempt governmental bonds if the debt service is paid from sources other than sports facility revenues or other private payments, such as generally applicable taxes.

### **Reasons for Change**

Allowing tax-exempt governmental bond financing of stadiums transfers the benefits of tax-exempt financing to private professional sports teams because these private parties benefit from significant use of the facilities. State and local governments subsidize that use with taxes or other governmental payments to enable the facilities to qualify for tax-exempt governmental bond financing. The current framework allowing professional sports facilities with significant private business use to qualify for tax-exempt governmental bond financing results in artificial financing structures to avoid violating the private payments test. Further, these financings may involve issuance of excessive amounts of tax-exempt bonds when localities offer to subsidize new stadiums for competitive purposes to attract or retain professional sports team franchises. Moreover, the current structuring of the governmental bonds to finance sports facilities has shifted more of the costs and risks from the private owners to local residents and taxpayers in general.

### **Proposal**

The proposal eliminates the private payments test for professional sports facilities. As a result, bonds to finance professional sports facilities would be taxable private activity bonds if more than 10 percent of the facility is used for private business use. By removing the private payment test, tax-exempt governmental bond financing of sports facilities with significant private business use by professional sports teams would be eliminated. The proposal would be effective for bonds issued after December 31, 2015.

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

### **Current Law**

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

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

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

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

### **Reasons for Change**

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

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

### **Proposal**

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

1. A qualified user (a State or local government or section 501(c)(3) nonprofit entity) would be required to own the research facilities.
2. A qualified user would be permitted to enter into any bona fide, arm's-length contractual arrangement with a private business sponsor of basic research regarding the terms for sharing the economic benefits of any products resulting from the research, including arrangements in which those economic terms (such as exclusive or non-exclusive licenses of intellectual property, and licensing fees or royalty rates) are determined in advance at the time the parties enter into the contractual arrangement.

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

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

### **Current Law**

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

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

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

### **Reasons for Change**

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

For State and local governments, the applicable two-part private business restriction standard for tax-exempt governmental bonds (as distinguished from private activity bonds) under section 141 involves established, well-known, and administrable tax standards. The private business use limitation particularly involves workable tax standards using general tax principles that focus on

ownership, leasing, and contractual rights. These standards focus eligibility for governmental bonds on the nature of the beneficiaries of the tax-exempt financing (rather than on the nature of the activities financed).

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

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

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

### **Proposal**

The proposal would adopt the State or local government standard for tax-exempt governmental bonds under section 141 without a bond volume cap on such governmental bonds (subject to restrictions discussed below). This standard is generally embodied in the limited authorization for Tribal Economic Development Bonds under section 7871(f) for purposes of Indian tribal governmental eligibility to issue tax-exempt governmental bonds. The proposal would repeal the existing essential governmental function standard for Indian tribal governmental tax-exempt bond financing under section 7871(c).

The proposal would allow Indian tribal governments to issue tax-exempt private activity bonds for the same types of projects and activities as are allowed for State and local governments under section 141(e), under a national bond volume cap. The same volume cap exceptions as those for State and local governments would apply in addition to the bonds being subject to restrictions discussed below. The proposal would employ a tailored version of a comparable annual tax-exempt private activity bond volume cap for Indian tribal governments. This tailored national Tribal private activity bond volume cap for all Indian tribal governments together as a group would be in an amount equal to the greater of: (i) a total national Indian tribal population-based measure determined under section 146(d)(1)(A) (applied by using such national Indian tribal population in lieu of State population), or (ii) the minimum small population-based State amount

under section 146(d)(1)(B). The proposal would delegate to the Department of the Treasury the responsibility to allocate that national bond volume cap among Indian tribal governments.

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

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

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

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

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would be effective for dispositions of U.S. real property interests occurring after December 31, 2015.

## **ELIMINATE FOSSIL FUEL TAX PREFERENCES**

### **ELIMINATE FOSSIL FUEL TAX PREFERENCES**

#### **Current Law**

Current law provides a number of credits, deductions and other special provisions that are targeted towards oil, gas and coal production. The following tax preferences are currently available for oil and natural gas activities:

#### **Enhanced oil recovery credit**

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

#### **Credit for oil and natural gas produced from marginal wells**

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



cents and \$1.67 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit has been completely phased out for all taxable years since its enactment. Unlike other components of the general business credit, which can be carried back only one year, the marginal well credit can be carried back up to five years. In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

### Expensing of intangible drilling costs

Special rules apply to intangible drilling costs (IDCs). IDCs include all expenditures made by an operator (i.e., a person who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and natural gas. In addition, IDCs include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and amounts properly allocable to the cost of depreciable property) done by contractors under any form of contract (including a turnkey contract). IDCs include amounts paid for labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and natural gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings) or items which are part of the acquisition price of an interest in the property. Under the special rules applicable to IDCs, an operator who pays or incurs IDCs in the development of an oil or natural gas property located in the United States may elect either to expense or capitalize those costs. The uniform capitalization rules do not apply to otherwise deductible IDCs. If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in the taxable year the cost is paid or incurred. Generally, IDCs that a taxpayer elects to capitalize may be recovered through depletion or depreciation, as appropriate; or in the case of a nonproductive well (“dry hole”), the operator may elect to deduct the costs. In the case of an integrated oil company (i.e., a company that engages, either directly or through a related enterprise, in substantial retailing or refining activities) that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period. A taxpayer that has elected to deduct IDCs may, nevertheless, elect to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate IDC adjustments or preferences under the alternative minimum tax. The election to deduct IDCs applies only to those IDCs associated with domestic properties. For this purpose, the United States includes certain wells drilled offshore.

### Deduction of costs paid or incurred for any tertiary injectant used as part of tertiary recovery method

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

### Exception to passive loss limitations provided to working interests in oil and natural gas properties

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Suspended deductions and credits are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses and credits from a passive activity are allowed in full when the taxpayer completely disposes of the activity. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. An exception is provided, however, for any working interest in an oil or natural gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.

### Use of percentage depletion with respect to oil and natural gas wells

The capital costs of oil and natural gas wells are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis. A taxpayer may also qualify for percentage depletion with respect to oil and natural gas properties. The amount of the deduction is a statutory percentage of the gross income from the property. For oil and natural gas properties, the percentage ranges from 15 to 25 percent and the deduction may not exceed 100 percent of the taxable income from the property (determined before the deductions for depletion and domestic manufacturing). In addition, the percentage depletion deduction for oil and natural gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before the deduction for depletion and with certain other adjustments). Other limitations and special rules apply to the percentage depletion deduction for oil and natural gas properties. In general, only independent producers and royalty owners (in contrast to integrated oil companies) qualify for the percentage depletion deduction. In addition, oil and natural gas producers may claim percentage depletion only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (applied on a combined basis in the case of taxpayers that produce both). This quantity limitation is allocated, at the taxpayer's election, between oil production and natural gas production and then further allocated within each class among the taxpayer's properties. Special rules apply to oil

and natural gas production from marginal wells (generally, wells for which the average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). Only marginal well production can qualify for percentage depletion at a rate of more than 15 percent. The rate is increased in a taxable year that begins in a calendar year following a calendar year during which the annual average unregulated wellhead price per barrel of domestic crude oil is less than \$20. The increase is one percentage point for each whole dollar of difference between the two amounts. In addition, marginal wells are exempt from the 100-percent-of-net-income limitation described above in taxable years beginning during the period 1998-2007 and in taxable years beginning during the period 2009-2011. Unless the taxpayer elects otherwise, marginal well production is given priority over other production in applying the 1,000-barrel limitation on percentage depletion. A qualifying taxpayer determines the depletion deduction for each oil and natural gas property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

#### Use of the domestic production manufacturing deduction

A deduction is allowed with respect to income attributable to domestic production activities (the manufacturing deduction). For taxable years beginning after 2009, the manufacturing deduction is generally equal to nine percent of the lesser of qualified production activities income for the taxable year or taxable income for the taxable year, limited to 50 percent of the W-2 wages of the taxpayer for the taxable year. The deduction for income from oil and natural gas production activities is computed at a six-percent rate. Qualified production activities income is generally calculated as a taxpayer's domestic production gross receipts (i.e., the gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States; any qualified film produced by the taxpayer; or electricity, natural gas, or potable water produced by the taxpayer in the United States) minus the cost of goods sold and other expenses, losses, or deductions attributable to such receipts. The manufacturing deduction generally is available to all taxpayers that generate qualified production activities income, which under current law includes income from the sale, exchange or disposition of oil, natural gas or primary products thereof produced in the United States.

#### 2-year amortization of independent producers' geological and geophysical expenditures

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

## Expensing of exploration and development costs

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale. Special rules apply in the case of mining exploration and development expenditures. A taxpayer may elect to expense the exploration costs incurred for the purpose of ascertaining the existence, location, extent, or quality of an ore or mineral deposit, including a deposit of coal or other hard mineral fossil fuel. Exploration costs that are expensed are recaptured when the mine reaches the producing stage either by a reduction in depletion deductions or, at the election of the taxpayer, by an inclusion in income in the year in which the mine reaches the producing stage. After the existence of a commercially marketable deposit has been disclosed, costs incurred for the development of a mine to exploit the deposit are deductible in the year paid or incurred unless the taxpayer elects to deduct the costs on a ratable basis as the minerals or ores produced from the deposit are sold. In the case of a corporation that elects to deduct exploration costs in the year paid or incurred, 30 percent of the otherwise deductible costs must be capitalized and amortized over a 60-month period. In addition, a taxpayer that has elected to deduct exploration costs may, nevertheless, elect to capitalize and amortize those costs over a 10-year period. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its exploration costs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate adjustments or preferences for exploration costs under the alternative minimum tax. Similar rules limiting corporate deductions and providing for 60- month and 10-year amortization apply with respect to mine development costs. The election to deduct exploration costs and the rule making development costs deductible in the year paid or incurred apply only with respect to domestic ore and mineral deposits.

## Percentage depletion for hard mineral fossil fuels

The capital costs of coal mines and other hard-mineral fossil-fuel properties are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis. A taxpayer may also qualify for percentage depletion with respect to coal and other hard-mineral fossil-fuel properties. The amount of the deduction is a statutory percentage of the gross income from the property. The percentage is 10 percent for coal and lignite and 15 percent for oil shale (other than oil shale to which a 7½-percent depletion rate applies because it is used for certain nonfuel purposes). The deduction may not exceed 50 percent of the taxable income from the property (determined before the deductions for depletion and domestic manufacturing). A qualifying taxpayer determines the depletion deduction for each property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

### Capital gains treatment for royalties

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

### Use of the domestic manufacturing deduction against income derived from the production of coal and other hard mineral fossil fuels

A deduction is allowed with respect to income attributable to domestic production activities (the manufacturing deduction). For taxable years beginning after 2009, the manufacturing deduction is generally equal to nine percent of the lesser of qualified production activities income for the taxable year or taxable income for the taxable year, limited to 50 percent of the W-2 wages of the taxpayer for the taxable year. Qualified production activities income is generally calculated as a taxpayer's domestic production gross receipts (i.e., the gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States; any qualified film produced by the taxpayer; or electricity, natural gas, or potable water produced by the taxpayer in the United States) minus the cost of goods sold and other expenses, losses, or deductions attributable to such receipts. The manufacturing deduction generally is available to all taxpayers that generate qualified production activities income, which under current law includes income from the sale, exchange or disposition of coal, other hard-mineral fossil fuels, or primary products thereof produced in the United States.

### Exemption from the corporate income tax for fossil fuel publicly traded partnerships

Publicly traded partnerships are generally subject to the corporate income tax. Partnerships that derive at least 90 percent of their gross income from depletable natural resources, real estate, or commodities are exempt from the corporate income tax. Instead they are taxed as partnerships. They pass through all income, gains, losses, deductions, and credits to their partners, with the partners then being liable for income tax (or benefitting from the losses) on their distributive shares.

### **Reasons for Change**

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels. The oil, gas, and coal tax preferences the Administration proposes to repeal distort markets by encouraging more investment in the fossil fuel sector than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and reducing greenhouse gas emissions. Moreover, the subsidies for oil, natural gas, and coal must ultimately be financed with taxes that cause further economic distortions including underinvestment in other, potentially more productive, areas of the economy.

## **Proposal**

The proposal would repeal: (1) the enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project; (2) the credit for oil and gas produced from marginal wells; (3) the expensing of intangible drilling costs; (4) the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method; (5) the exception to passive loss limitations provided to working interests in oil and natural gas properties; (6) the use of percentage depletion with respect to oil and gas wells; (7) the ability to claim the domestic production manufacturing deduction against income derived from the production of oil and gas; (8) two-year amortization of independent producers' geological and geophysical expenditures, instead allowing amortization over the seven-year period used by integrated oil and gas producers; (9) expensing of exploration and development costs; (10) percentage depletion for hard mineral fossil fuels; (11) capital gains treatment for royalties; (12) the ability to claim the domestic manufacturing deduction against income derived from the production of coal and other hard mineral fossil fuels; and (13) the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels.

Proposal parts (1) – (12) would be effective for production or for costs incurred after December 31, 2015, and, in the case of royalties, for amounts realized after taxable years beginning December 31, 2015. Proposal part (13), taxing fossil fuel publicly traded partnerships as C corporations, would be effective after December 31, 2020.

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

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

#### **Current Law**

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

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

In addition to forwards, futures, options, and NPCs, there are contractual arrangements such as convertible debt, contingent debt, structured notes, and securities lending transactions that either are themselves derivatives or contain embedded derivatives. Different timing and character rules apply to these instruments. Contingent debt, for example, requires the holder to accrue current income based on the payments the holder would receive from a comparable noncontingent bond of the issuer, with adjustments for payments that differ from the projected payment schedule. Both income and gain from a contingent debt instrument is generally ordinary. In the case of a structured note (which includes many exchange traded notes), the tax rules are unclear. Structured note holders generally take the view that no income or gain is recognized until the structured note matures or is sold, and they treat the gain or loss as capital. Similarly, taxpayers that enter into a securities lending transaction have disposed of their securities in exchange for a contractual right to have the securities returned upon request. Section 1058, however, provides that no gain or loss is recognized as long as the securities loan satisfies certain criteria. The recognition of gain or loss on a securities lending transaction is therefore dependent on whether the transaction satisfies the requirements of section 1058.

## **Reasons for Change**

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

## **Proposal**

The proposal would require that gain or loss from a derivative contract be marked to market no later than the last business day of the taxpayer's taxable year. Gain or loss resulting from the contract would be treated as ordinary and as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4). The source of income associated with a derivative would continue to be determined under current law.

A derivative contract would be broadly defined to include any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property. A derivative contract that is embedded in another financial instrument or contract would be subject to mark to market if the derivative by itself would be marked to market. Consequently, mark to market treatment would apply to contingent debt and structured notes linked to actively traded property. In addition, a taxpayer that enters into a derivative contract that substantially diminishes the risk of loss on actively traded stock that is not otherwise marked to market would be required to mark the stock to market, with preexisting gain recognized at that time and loss recognized when the financial instrument would have been recognized in the absence of the straddle. The proposal would expressly provide the Secretary with the authority to issue regulations that match the timing, source, and character of income, gain, deduction, and loss from a capital asset and a transaction that diminishes the risk of loss or opportunity for gain from that asset. For example, in the case of stock issued by a U.S. corporation, the source of dividends on the stock would be U.S., while gain or loss on a sale of the stock is generally sourced based on the residence of the recipient. Thus, if a taxpayer were to hedge the stock with a notional principal contract (NPC), the Secretary would have the authority to write regulations that provide that dividend equivalent payments on the NPC are matched to the dividends on the stock for timing, source, and character, while gain or loss on the NPC could be matched to the gain or loss on the stock for timing, source, and character.

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



The proposal would eliminate or amend a number of provisions in the Code that address specific taxpayers and transactions, including section 475, section 1256 (mark to market and 60/40 capital gain), section 1092 (tax straddles), section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sales transactions), and section 1260 (constructive ownership transactions).

The proposal would apply to derivative contracts entered into after December 31, 2015.

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

### **Current Law**

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

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

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

### **Reasons for Change**

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

### **Proposal**

The proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 to report the purchase price, the buyer's and seller's TINs, and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The proposal also would modify the transfer-for-value rule by eliminating the exception that currently applies if the buyer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. Instead, under the proposal, the rule would not apply in the case of a transfer to the insured, or to a partnership or a corporation of which the insured is a 20-percent owner. Other exceptions to the rule would continue to apply.

The proposal would apply to sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2015.

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

### **Current Law**

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

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

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

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

### **Reasons for Change**

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

## **Proposal**

The proposal would replace the existing regime for prorating investment income of a life insurance company between the “company’s share” and the “policyholders’ share” with a proration regime that is simpler. As under current law, a company's share and policyholders’ share would be calculated for a life insurance company's general account and individually for each of its separate accounts. However, the policyholders’ share would equal the ratio of an account's mean reserves to its mean assets, and the company's share would equal one less the policyholders’ share. The proposal would thus put the company’s general and separate accounts on a similar footing to that of any other taxpayer with a diminished risk of loss in stock that it owns, or with an obligation to make related payments with regard to dividends.

The proposal would be effective for taxable years beginning after December 31, 2015.

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

### **Current Law**

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

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

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would apply to contracts issued after December 31, 2015, in taxable years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would be treated as a new contract except that in the case of a master contract, the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

## **CONFORM NET OPERATING LOSS RULES OF LIFE INSURANCE COMPANIES TO THOSE OF OTHER CORPORATIONS**

### **Current Law**

Current law generally allows businesses to carry back a net operating loss (NOL) up to two taxable years preceding the taxable year of loss (loss year) and to carry forward an NOL up to 20 taxable years following the loss year. Life insurance companies, however, that have a loss from operations (LO) – a life insurance company’s NOL equivalent – may carry back the LO up to three taxable years preceding the loss year, and carry forward an LO up to 15 taxable years following the loss year.

Prior to the enactment of the Taxpayer Relief Act of 1997 (TRA 1997), the provisions governing the carrying back and forward of NOLs specified a three-year carryback period and a 15-year carryforward period. A separate Code provision provided, and continues to do so, the carryback and carry forward periods for a life insurance company’s LO. TRA 1997 did not modify the LO carryback and carryforward periods to conform to the modified NOL carryback and carryforward periods.

### **Reasons for Change**

A longer carryback period enhances the neutrality of the Code by allowing more opportunity for losses to be absorbed immediately, without potentially postponing a taxpayer’s refund or tax savings until the carried forward NOL is utilized. Nevertheless, there is not a compelling reason why losses incurred by life insurance companies should be assigned more favorable tax treatment under the Code than that granted other taxpayers.

### **Proposal**

The proposal would reestablish NOL and LO conformity by allowing a life insurance company’s LO to be carried back up to two taxable years prior to the loss year, and carried forward 20 taxable years following the loss year.

The proposal would be effective for taxable years beginning after December 31, 2015.



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

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

#### **Current Law**

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

#### **Reasons for Change**

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

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

#### **Proposal**

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

The repeal is proposed to be effective for the first taxable year beginning after December 31, 2015.

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would be effective for taxable years beginning after December 31, 2015.

## **MODIFY LIKE-KIND EXCHANGE RULES FOR REAL PROPERTY AND COLLECTIBLES**

### **Current Law**

When capital assets are sold or exchanged, capital gain or loss is generally recognized. Under section 1031, however, no gain or loss is recognized when business or investment property is exchanged for “like-kind” business or investment property. As a result, the tax on capital gain is deferred until a later realization event, provided that certain requirements are met. The “like-kind” standard under section 1031, which focuses on the legal character of the property, allows for deferral of tax on the exchange of improved and unimproved real estate. Certain properties, including stocks, bonds, notes or other securities or evidences of indebtedness are excluded from nonrecognition treatment under section 1031. Exchanges of art and collectibles for investment are eligible for deferral of gain under section 1031.

### **Reasons for Change**

There is little justification for allowing deferral of the capital gain on the exchange of real property or art and collectibles. Historically, section 1031 deferral has been justified on the basis that valuing exchanged property is difficult. However, for the exchange of one property for another of equal value to occur, taxpayers must be able to value the properties. In addition, many, if not most, exchanges affected by this proposal are facilitated by qualified intermediaries who help satisfy the exchange requirement by selling the exchanged property and acquiring the replacement property. These complex three-party exchanges were not contemplated when the provision was enacted. They highlight the fact that valuation of exchanged property is not the hurdle it was when the provision was originally enacted. Further, the ability to exchange unimproved real estate for improved real estate encourages “permanent deferral” by allowing taxpayers to continue the cycle of tax deferred exchanges.

### **Proposal**

The proposal would limit the amount of capital gain deferred under section 1031 from the exchange of real property to \$1 million (indexed for inflation) per taxpayer per taxable year. The proposal limits the amount of real estate gain that qualifies for deferral while preserving the ability of small businesses to generally continue current practices and maintain their investment in capital. In addition, art and collectibles would no longer be eligible for like-kind exchanges. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The provision would be effective for like-kind exchanges completed after December 31, 2015.

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

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

The proposal would be effective for property placed in service after December 31, 2015.

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

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

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

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

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

## **DENY DEDUCTION FOR PUNITIVE DAMAGES**

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would apply to damages paid or incurred after December 31, 2015.



## **CONFORM CORPORATE OWNERSHIP STANDARDS**

### **Current Law**

For tax-free transfers of assets to controlled corporations in exchange for stock, tax-free distributions of controlled corporations, and tax-free corporate reorganizations, “control” is defined in section 368 as the ownership of 80 percent of the voting stock and 80 percent of the number of shares of all other classes of stock of the corporation. The section 368 control test is also incorporated by cross-reference in other sections of the Code relating to discharge of indebtedness income, non-deductibility of interest on corporate acquisition indebtedness, installment obligations, qualified small business stock, and qualifying as an S corporation. In contrast, the “affiliation” test under section 1504 for permitting two or more corporations to file consolidated returns is the direct or indirect ownership by a parent corporation of at least 80 percent of the total voting power of another corporation’s stock and at least 80 percent of the total value of the corporation’s stock. Several other Code provisions, including rules relating to tax-free parent-subsidiary liquidations, and qualified stock purchases and dispositions incorporate by cross-reference the affiliation test.

Prior to 1984, the affiliation test required ownership of 80 percent of the voting stock and 80 percent of the number of shares of all other classes of stock of the corporation, similar to the control test. Congress amended the affiliation test in 1984 in response to concerns that corporations were filing consolidated returns under circumstances in which a parent corporation’s interest in the issuing corporation accounted for less than 80 percent of the equity value of such corporation. In 1986, the affiliation test became the ownership standard for tax-free parent-subsidiary liquidations and qualified stock purchases and dispositions. In 2006, the Code was amended to provide that the affiliation test applies to determine whether a distributing or controlled corporation satisfied the active trade or business requirement for a tax-free distribution of subsidiary stock.

### **Reasons for Change**

By carefully allocating voting power among the shares of a corporation, taxpayers can manipulate the control test in order to qualify or not qualify, as desired, a transaction as tax-free (for example, a transaction could be structured to avoid tax-free treatment to recognize a loss). In addition, the absence of a value component allows corporations to retain control of a corporation but to “sell” a significant amount of the value of the corporation tax-free. Congress amended the affiliation test in 1984 to address similar concerns regarding the manipulation of the vote and value of affiliated corporations. A uniform ownership test for corporate transactions will also reduce complexity currently caused by these inconsistent tests.

### **Proposal**

The proposal would conform the control test under section 368 with the affiliation test under section 1504. Thus, “control” would be defined as the ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of stock of a corporation. For this

purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4).

The proposal would be effective for transactions occurring after December 31, 2015.

## TAX CORPORATE DISTRIBUTIONS AS DIVIDENDS

### Current Law

Section 301 provides rules for characterizing a distribution of property by a corporation to a shareholder. The amount of the distribution is first treated as a dividend under section 301(c)(1) to the extent of the distributing corporation's applicable earnings and profits. Outside the corporate reorganization and spin-off contexts, section 316 provides that all of a corporation's current and accumulated earnings and profits are taken into account in determining the extent to which a distribution of property made by the corporation is taxed as a dividend. The amount of the corporation's earnings and profits at the time the distribution is made is not controlling. Rather, earnings and profits of a corporation are generally computed on a standalone basis as of the close of the corporation's taxable year in which the distribution is made without diminution as a result of distributions made during the taxable year. Special rules apply for consolidated groups, and in the case of a deemed dividend resulting from a sale of stock of a controlled foreign corporation (CFC), as defined in section 957.

The portion of the distribution received by the shareholder that is not a dividend is applied against and reduces the shareholder's adjusted basis of the corporation's stock under section 301(c)(2), and any amount distributed in excess of the shareholder's basis that is not a dividend is treated as gain from the sale or exchange of property under section 301(c)(3). The shareholder takes a basis in the distributed property equal to its fair market value under section 301(d).

Generally, the corporation is required to recognize under section 311(b) any gain realized on the distribution of any appreciated property to a shareholder (and its earnings and profits are increased by such gain under section 312), but does not recognize under section 311(a) any loss realized on a distribution of property with respect to its stock. Although the corporation does not recognize a loss, its earnings and profits are decreased under section 312 by the sum of the amount of money, the principal amount or issue price of any obligations (as the case may be), and the adjusted basis of any other property, so distributed.

If an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder's basis in any remaining stock of the corporation is increased by the shareholder's basis in the redeemed stock. In addition, if a subsidiary corporation acquires in exchange for cash or other property stock of a direct or indirect corporate shareholder issued by that corporation (often referred to as "hook stock"), the issuing corporation does not recognize gain or loss (or any income) under section 1032 upon the receipt of the subsidiary's cash or other property in exchange for issuing the hook stock.

If as part of a corporate reorganization a shareholder receives in exchange for stock of the target corporation both stock and property not permitted to be received without the recognition of gain (often referred to as "boot"), the exchanging shareholder is required to recognize under section 356(a)(1) gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the "boot-within-gain" limitation). If the exchange has the effect of the distribution of a dividend, then section 356(a)(2) provides that all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the

shareholder's ratable share of the corporation's earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

### **Reasons for Change**

Corporations have devised many ways to avoid dividend treatment under current law. For example, corporations can enter into preparatory transactions to eliminate a corporation's earnings and profits or shift the corporation's earnings and profits to a prior or subsequent tax year. Corporations also enter into transactions (so-called "leveraged distributions") to avoid dividend treatment upon a distribution by having a corporation with earnings and profits provide funds (for example, through a loan) to a related corporation with no or little earnings and profits, but in which the distributee shareholder has high stock basis. In addition, because current law permits a corporation to receive cash without recognizing any income in exchange for issuing its stock, subsidiaries may distribute property tax-free to corporate shareholders in exchange for stock issued by such shareholder.

Under current law, these types of transactions reduce earnings and profits for the year in which a distribution is made without a commensurate reduction in a corporation's dividend paying capacity. Such transactions are inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation's dividend-paying capacity, and these transactions inappropriately result in the avoidance of dividend treatment for the corporation's shareholders. Finally, there is not a significant policy reason to vary the tax treatment of a distribution received in a reorganization (and currently subject to the boot-within-gain limitation of section 356) with the treatment afforded ordinary distributions under section 301.

### **Proposal**

The Administration proposes to amend the Code to ensure that a transfer of property by a corporation to its shareholder better reflects the corporation's dividend-paying capacity.

#### **Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions**

The proposal would amend section 312(a)(3) to provide that earnings and profits are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective on the date of enactment.

#### **Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment**

The proposal would treat a leveraged distribution from a corporation (distributing corporation) to its shareholder(s) that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation (funding corporation) to the extent the funding corporation funded the

distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation. This proposal revises the Administration's previous proposal to disregard a shareholder's basis in stock of a distributing corporation for purposes of recovering such basis under section 301(c)(2).

The proposal would be effective for transactions occurring after December 31, 2015.

Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions

The proposal would disregard a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entities) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would grant the Secretary authority to prescribe regulations to treat purchases of interests in shareholder entities other than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2015.

Repeal gain limitation for dividends received in reorganization exchanges

The proposal would repeal the boot-within-gain limitation in reorganization transactions in which the shareholder's exchange is treated under section 356(a)(2) as having the effect of the distribution of a dividend. For this purpose, the Administration also proposes to align the available pool of earnings and profits to test for dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2015.

## **REPEAL FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA) TIP CREDIT**

### **Current Law**

Employee tip income is treated as employer-provided wages subject to income and employment taxes under FICA. Employees who receive tips of \$20 or more in a calendar month are required to report the amount of tips to their employers. Employers are responsible for withholding employee income tax and the employee's share of FICA taxes and paying the employer's share of FICA taxes on the reported tips.

An eligible employer may claim a credit against the business's income taxes for FICA taxes paid on certain tip wages. The credit applies to the employer's share of FICA taxes paid on the portion of tips, when added to the employee's non-tip wages, in excess of \$5.15 per hour. The credit applies only with respect to FICA taxes paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees providing, delivering or serving food or beverages by customers is customary. The credit against income tax is for the full amount of eligible FICA taxes. The credit is available whether or not the employee reports the tips on which the employer FICA taxes were paid. The credit is non-refundable and subject to carryback and carryforward provisions. Employers cannot deduct from taxable income the amount of FICA taxes taken into account in determining the credit. A taxpayer may elect not to have the credit apply for a taxable year.

### **Reasons for Change**

The current FICA tip credit is inefficient and inequitable. The favorable tax treatment on tips relative to other cash compensation unduly encourages employers to provide income in the form of tips instead of wages. In addition, while the credit was intended to address underreporting of tip income, the FICA tax gap on tip income remains large in the applicable industries and the credit costs far more than any positive effect on tax compliance. Further, only certain employers in the food and beverage service sectors are entitled to a tax credit for the FICA taxes they pay on employee tip income. No other industries in which the tipping of employees is customary receive a similar tax credit, and the current FICA tip credit is unfair to taxpayers who are voluntarily compliant with tax law without receiving any tax subsidy.

### **Proposal**

The proposal would repeal the income tax credit for FICA taxes an employer pays on tips.

The proposal would be effective for taxable years beginning after December 31, 2015.

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

### **Current Law**

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

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

### **Reasons for Change**

The tax credit introduces differences in the prices of similar goods, and thereby distorts decisions by producers and consumers. Consumers may favor distilled spirit products with additives because of their comparatively lower price, relative to similar products with the same overall alcohol content but without additives. In addition, the credit encourages producers to use additives. In the first year following the enactment of the credit (1981), roughly one million proof-gallons of wines and flavors were mixed with 300 million proof-gallons of spirits. Since then the volume of wines and flavors have increased substantially while the volume of spirits used in mixed products has stayed roughly constant. In 2013, 12.6 million proof gallons of wines and flavors were mixed with 330 million gallons of spirits within the United States.

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

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

### **Proposal**

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

The proposal would be effective for all spirits produced in or imported into the United States after December 31, 2015.





## **BUDGET PROPOSALS**

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The Administration's receipt proposals begin the process of comprehensively reforming the Internal Revenue Code to help address the challenges that working families face. These proposals help make work pay by expanding the EITC for workers without qualifying children and creating a new second earner credit, reform and simplify tax incentives that help families save for retirement and pay for college and child care, and reform capital gains taxation to eliminate a loophole that lets substantial capital gains income escape tax. They also reduce the deficit and make the tax system fairer by eliminating a number of tax loopholes and reducing tax benefits for higher-income taxpayers. The Administration's proposals that affect receipts are described below.

# **TAX REFORM FOR FAMILIES AND INDIVIDUALS**

## **REFORM CHILD CARE TAX INCENTIVES**

### **Current Law**

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

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

Taxpayers may also be offered dependent care assistance through their employers. Employers may provide assistance directly or, more commonly, allow employees to set aside funds for child and dependent care in a flexible spending account (FSA). Up to \$5,000 in assistance or employee contributions is excludable from employee wages for income and payroll tax purposes (\$2,500 for married persons filing separate returns). As with the child and dependent care tax credit, excluded amounts must be used to provide care for a child who is under age 13 or a disabled dependent, so that the taxpayer can work or look for work (or, in the case of one spouse in a married couple, attend school). The maximum allowable expense for child and dependent care for purposes of the credit must be reduced by any employer assistance that is excluded from wages. For example, a taxpayer who sets aside \$5,000 for expenses in a child care FSA may not claim any credit for expenses paid for only one child and may claim a credit on expenses of up to \$1,000 for two or more children.

### **Reasons for Change**

Access to affordable child care is a barrier to employment or further schooling for some individuals. Although the child and dependent care tax credit partially offsets these costs, the value of the credit has eroded over time because income level at which the credit begins to phase-down and the expense limit are not indexed for inflation.

Dependent care flexible spending accounts provide tax benefits to workers with children, but are not universally offered by employers, thereby creating inequities across families. Furthermore, participation in a flexible spending account requires taxpayers to predict how much child care expenses will be incurred and could result in a loss of income if the total amount allocated is not spent.

Child care costs are particularly high among families with children under age five because these children are generally too young to attend elementary school and because care for very young children may be more expensive. In addition to imposing a financial burden on working families, these additional costs are an impediment to reentry into the workforce by parents. Empirical evidence suggests that mothers of children under age five have lower rates of labor force participation and employment than mothers of older children, suggesting that child care costs may delay employment for mothers who would prefer to return to market work. Expanding child care assistance to taxpayers with children reduces disincentives for these parents to participate in the labor force or in education programs.

### **Proposal**

The proposal would repeal dependent care flexible spending accounts, increase the child and dependent care credit, and create a larger credit for taxpayers with children under age five. The income level at which the current-law credit begins to phase down would be increased from \$15,000 to \$120,000, such that the rate reaches 20 percent at income above \$148,000. Taxpayers with young children could claim a child care credit of up to 50 percent of expenses up to \$6,000 (\$12,000 for two young children). The credit rate for the young child credit would phase down at a rate of one percentage point for every \$2,000 (or part thereof) of AGI over \$120,000 until the rate reaches 20 percent for taxpayers with incomes above \$178,000. The expense limits and income at which the credit rates begin to phase down would be indexed for inflation for both young children and other dependents after 2016.

The proposal would be effective for taxable years beginning after December 31, 2015.

## **SIMPLIFY AND BETTER TARGET TAX BENEFITS FOR EDUCATION**

### **Current Law**

The tax code includes several benefits to help families pay for higher education.

#### **Education tax credits**

ARRA created the American Opportunity Tax Credit (AOTC) to replace the Hope Scholarship credit. Taxpayers may claim an AOTC for 100 percent of the first \$2,000 plus 25 percent of the next \$2,000 of qualified tuition and related expenses for a maximum credit of \$2,500 for each student enrolled in an eligible educational institution at least half-time. Taxpayers with little or no income tax liability may still claim 40 percent of the otherwise allowable AOTC, or a maximum of \$1,000, as a refundable credit. The AOTC is available for the first four years of postsecondary education. Expenses incurred by a dependent are treated as being paid by the taxpayer claiming the dependent exemption. However, students who could be, but are not, claimed as a dependent on someone else's tax return may claim the nonrefundable portion of the AOTC for themselves on their own tax return if they are otherwise eligible. The AOTC phases out for taxpayers with AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for joint filers). Neither the AOTC expense amounts nor income phaseout limits are indexed for inflation. The AOTC expires after December 31, 2017, at which time the more limited Hope Scholarship credit will again be available.

Taxpayers who do not claim the AOTC may be eligible to claim a nonrefundable Lifetime Learning Credit of 20 percent of up to \$10,000 in qualified tuition and related expenses for a maximum credit of \$2,000 per return, per year. Unlike the AOTC and Hope Scholarship credit, a student may be eligible for the Lifetime Learning Credit for an unlimited number of years and may be enrolled less than half-time. In 2015, the Lifetime Learning Credit phases out between \$55,000 and \$65,000 of AGI (\$110,000 and \$130,000 if married filing jointly). The Lifetime Learning Credit expense limit is not indexed for inflation but the Lifetime Learning Credit phaseout limit is indexed for inflation.

Taxpayers who receive scholarships or grants that are used to pay for qualifying expenses (tuition, fees, or books, for example) may choose to exclude them from the gross income of the student. However, any scholarship or grant that is excluded from gross income must be subtracted from expenses that might otherwise qualify for an AOTC or Lifetime Learning Credit. Thus, Pell Grants that are not included in income reduce the amount of expenses that qualify for an AOTC or Lifetime Learning Credit. Typically, Pell Grant recipients are among the neediest students. The vast majority of recipients have family income under \$30,000. The maximum Pell Grant for the 2014-2015 award year is \$5,730.

#### **Form 1098-T reporting of tuition expenses and scholarships**

Form 1098-T is used to verify education spending for education-related tax benefits. Institutions of higher learning are generally required to file an information return (Form 1098-T) each year for each enrolled student. When filing Form 1098-T, institutions have the choice of reporting

payments received for qualified tuition and related expenses (Box 1) or amounts billed for qualified tuition and related expenses (Box 2) in a given tax year.

Institutions of higher education are also required to report scholarships and grants (Box 5) that they administer or distribute (for instance Pell Grants). Other entities that provide scholarships and grants are not required to file Form 1098-T to report these amounts to students or to the IRS.

### Student loans

Students with higher-education expenses may be eligible to borrow money for their education privately or through Federal programs. Taxpayers who pay interest on Federal or other education loans may be eligible to deduct up to \$2,500 of such interest paid from gross income whether or not they itemize deductions. The student loan interest deduction phases out for taxpayers with modified AGI between \$65,000 and \$80,000 (\$130,000 and \$160,000 if married filing jointly) in 2015.

To reduce Federal student loan repayment burden and defaults, these programs include a number of income-driven payment plan options that decrease monthly payments and limit the number of years that payments will be required before the loans are forgiven. For example, under the recently expanded Pay-As-You-Earn (PAYE) plan, monthly payments are limited to 10 percent of AGI in excess of 150 percent of the Federal poverty line and debt is forgiven after payments have been made for 20 years. Like most forgiven debt, the forgiven balance is income to the borrower and subject to individual income tax.

Generally, tax return information, including taxpayer identity information (the name, address, and TIN of the person with respect to whom a return is filed), is confidential and can only be used for tax administration. An exception permits the disclosure of taxpayer identity information to the Department of Education, and re-disclosure by the Department of Education to certain lenders, guarantee agencies, and educational institutions, for purposes of collecting defaulted student loans.

### Indian Health Service (IHS) Scholarship Programs and Loan Forgiveness Programs

The IHS Health Professions Scholarship Program and IHS Loan Forgiveness Program improve access to medical care for Indian and Alaska Natives by providing physicians and other health professionals to IHS facilities. Participants in the scholarship program commit to a term of employment at IHS facilities upon completion of their training. Participants in the loan repayment program serve at IHS facilities in exchange for loan repayment. Because the scholarship includes a work obligation, the scholarship funds are considered ordinary income and subject to taxation. Loan amounts repaid on behalf of program participants are also considered ordinary income and subject to taxation.

The National Health Service Corps (NHSC) operates two similar health programs; in fact, IHS facilities are approved locations for NHSC participants. In contrast to the IHS, participants in the NHSC scholarship program may exclude scholarship amounts used for qualifying expenses from income, and participants in the NHSC loan program may exclude any loan amounts repaid

on their behalf from income. Some States operate loan programs that receive the same tax treatment as the NHSC loan program. The military offers the Armed Forces Health Professions scholarships, which receive the same preferential tax treatment as the NHSC scholarship program.

### Education Savings Accounts

There are two types of Education Savings Accounts (ESAs) under current law, Coverdell ESAs and savings plans offered as part of a Qualified Tuition Programs (QTPs are also known as section 529 plans). QTPs include both pre-paid tuition plans and savings plans. QTPs (with one exception) are run by the States. Under the pre-paid tuition plans, families purchase or “pre-pay” for a certain number of credit hours with the expectation that their child will attend a public college or university in the State or at a participating private college or university. Under savings plans, families save for college by investing in one or more of the portfolios offered by a State savings plan.

Contributions to Coverdell ESAs and QTP savings plans are not deductible from income. Contributions to Coverdell ESAs are limited to \$2,000 per tax return per year and the allowable contribution amount is phased out between modified AGI of \$95,000 and \$110,000 (\$190,000 and \$220,000 if filing a joint return). Contribution amounts to QTP savings plans are virtually unlimited, and there are no income limitations on the contributors. Earnings on investments in Coverdell ESAs and QTP savings plans accrue tax free, and distributions for qualified expenses are not taxed. If the distributions are not used for qualified education expenses because the beneficiary died or received a scholarship the share of distributions attributable to earnings on the contributions are subject to income tax. If the distributions are otherwise not used for qualified education expenses, the distributions attributable to earnings are subject to income tax and a 10-percent additional tax.

### Reasons for Change

Providing multiple tax benefits for higher education creates needless complexity and taxpayer burden. Recent research has found that when faced with multiple tax benefits, a substantial number of taxpayers do not select the benefit that offers the largest reduction in tax liability.

The AOTC makes college more affordable for millions of families. Because the AOTC is partially refundable, families without a sufficient income tax liability who could not benefit from the Hope Scholarship credit or the Lifetime Learning Credit can benefit from the AOTC. But the AOTC could do more to help low- and moderate-income families and to help students complete their degrees. Less than half of the AOTC credit is refundable and the formula for computing the refundable portion is unnecessarily complicated. The AOTC is also only available for the first four years of postsecondary education and for four tax years when most students take more than four tax years to complete a bachelor’s degree, including students who matriculate in the fall and graduate in four years. Meanwhile, some high-income families are benefitting from a loophole in current law that allows their children to claim a nonrefundable AOTC if the parents do not claim them on their tax return, thus avoiding the AOTC’s income limits.

The lack of coordination between Federal grant and tax benefits is also preventing many low-income students from benefitting from the tax credits. Many students eligible for a Pell Grant are also eligible for education tax credits. However, in order to claim those tax benefits, students who receive a Pell Grant may need to use some or all of their Pell Grant to pay for living expenses and include that portion of the Pell Grant in income. Calculating the optimal amount of scholarships to include in gross income is very complicated and may require students to pay tax on their Pell Grant. Excluding the entire Pell Grant from gross income and from the AOTC or Lifetime Learning Credit calculation would make it easier for students to claim benefits for which they are currently eligible and to benefit more completely from both programs.

The lack of complete information reporting may also be preventing some students from benefitting from the tax credits. Currently, Form 1098-T may not provide all the information that taxpayers need to claim an education tax credit or to properly report taxable scholarship income. Many institutions that file Form 1098-T report amounts billed. However only amounts paid in a given tax year qualify for a tax credit in that tax year. (Amounts billed will not qualify for the credits if the amount was paid in a different tax year.) Scholarships that are paid directly to students rather than administered by schools are not reported on Form 1098-T to students or to the IRS. Requiring institutions of higher learning to report amounts paid and requiring reporting of all scholarships will assist taxpayers in preparing their returns and allow IRS to monitor and improve compliance.

Many students finance their educations with student loans, sometimes at levels that are difficult to manage at their post-education incomes. More immediate and direct assistance, such as through tax credits to offset expenses while the student is enrolled, are likely to be more effective than the student loan interest deduction in helping students complete their educations and achieve financial security.

In addition, income-driven payment plans are more effective in helping graduates manage debt burden than the student loan interest deduction. Individuals who have their student loans forgiven under PAYE or other income-driven repayment plans will have been making payments for many years. Many of these individuals will have had low incomes relative to their debt burden for much or all of this time. For many of these individuals, paying the tax on the forgiven amounts will be difficult.

Locating delinquent borrowers and providing them with payment options before they default on their student loans is often difficult because of the lack of current name and address information. Many of these delinquent borrowers are eligible for income-driven repayment plans.

The IHS Health Professions Scholarship and IHS Loan Forgiveness Program are very similar to other programs intended to increase the availability of health care services to underserved populations that receive preferred tax treatment, and should therefore receive similar tax treatment.

## **Proposal**

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

### **Expand and modify the AOTC and repeal Lifetime Learning Credits**

To further increase tax benefits available to students while they are in college and simplify the claiming of tax benefits, the Administration proposes to replace the Lifetime Learning Credit and student loan interest deduction with an expanded AOTC. The expanded AOTC would be available for the first five years of postsecondary education and for five tax years. It would expand eligibility to include less than half-time undergraduate students. The proposal would simplify and increase the refundable portion of the AOTC, and it would index expense limits and the refundable amount for inflation after 2016.

Eligible students attending school at least half-time would still be able to claim an AOTC equal to 100 percent of the first \$2,000 of eligible expenses and 25 percent of the next \$2,000 of eligible expenses. The first \$1,500 of the otherwise allowable credit would be refundable. Eligible students attending school less than half-time would be able to claim a part-time AOTC equal to 50 percent of the first \$2,000 of eligible expenses plus 12.5 percent of the next \$2,000 of eligible expenses. The first \$750 of the part-time AOTC would be refundable.

Under the proposal, students who can be claimed as a dependent on someone else's tax return could no longer claim the nonrefundable portion of the AOTC on their own return.

### **Make Pell Grants excludable from income**

To further simplify education benefits for low-income students, the proposal would exclude all Pell Grants from gross income and the AOTC calculation, such that taxpayers can claim an AOTC without reducing eligible expenses for claiming the credit by the amount of their Pell Grant.

### **Modify reporting of tuition expenses and scholarships on Form 1098-T**

The proposal would require institutions of higher education to report amounts paid, not billed, on Form 1098-T and require any entity issuing a scholarship or grant in excess of \$500 (indexed for inflation after 2016) that is not processed or administered by an institution of higher education to report the scholarship or grant on Form 1098-T.

### **Repeal the student loan interest deduction and provide exclusion for certain debt relief and scholarships**

The Administration proposes four changes to the tax rules governing student loans. First, the proposal would repeal the deduction for student loan interest for new students. New students would benefit from the expanded AOTC, reducing their need to borrow, and recently expanded income-driven repayment (IDR) options are better targeted and more effective approaches to



reducing the burden of student loan repayment. These IDR programs limit payments to affordable levels and forgive remaining balances after a limited repayment period. The proposal would exclude the forgiven portion of a Federal student loan from gross income.

Second, the proposal would conform the tax treatment of loan amounts repaid by IHS to the tax treatment of loan amounts paid by NHSC and certain State programs intended to increase the availability of health care services to underserved populations. Third, the proposal would also conform the tax treatment of IHS Health Professions Scholarships to the tax treatment of NHSC scholarships and Armed Forces Health Professions (AFHP) scholarships.

Fourth, the proposal would allow the Secretary to disclose identifying information to the Department of Education for the purpose of contacting late-stage delinquent borrowers to inform them about options for avoiding default. The proposal would also allow the Department of Education to re-disclose this information, as under current law for defaulted borrowers, to certain lenders, guarantee agencies, and educational institutions for this purpose.

#### Repeal Coverdells and reduce the Federal tax benefits of qualified tuition programs

To help pay for the expanded benefits, the Administration proposes to repeal Coverdell ESAs and reduce the Federal tax benefits allowed to qualified tuition programs, also known as section 529 ESAs. No new contributions would be allowed to Coverdell ESAs. Qualifying distributions of earnings on contributions to Coverdell and section 529 ESAs made prior to the date of enactment would continue to be excludable from gross income. Distributions of earnings on contributions to section 529 ESAs made after the date of enactment would no longer be excludable from gross income but would still benefit from being includable only in the gross income of the student beneficiary, not the gross income of the account holder.

The proposal would generally be effective for taxable years beginning after December 31, 2015, except that the provisions regarding student loan forgiveness would be effective for discharges of loans after December 31, 2015 and the provisions expanding disclosure of taxpayer identifying information for late-stage delinquency would be effective upon enactment.

## **PROVIDE FOR AUTOMATIC ENROLLMENT IN IRAS, INCLUDING A SMALL EMPLOYER TAX CREDIT, INCREASE THE TAX CREDIT FOR SMALL EMPLOYER PLAN START-UP COSTS, AND PROVIDE AN ADDITIONAL TAX CREDIT FOR SMALL EMPLOYER PLANS NEWLY OFFERING AUTO-ENROLLMENT**

### **Current Law**

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

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

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

For 2015, IRA contributions are limited to \$5,500 a year (plus \$1,000 for those age 50 or older). Section 401(k) plans can permit contributions (employee plus employer contributions) of up to \$53,000 a year (of which \$18,000 can be pre-tax employee contributions) plus \$6,000 of additional pre-tax employee contributions for those age 50 or older.

### **Reasons for Change**

Tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In addition, the proportion of U.S. workers participating in employer-sponsored plans has remained stagnant for decades at no more than about half the total work force, notwithstanding repeated private- and public-sector efforts to expand coverage. Many employees eligible to participate in an employer-sponsored retirement savings plan such as a 401(k) plan do not participate, but making saving easier by making it automatic has been shown to be remarkably effective at boosting participation.

Beginning in 1998, Treasury and the IRS issued a series of rulings and other guidance defining, permitting, and encouraging automatic enrollment in 401(k) and other plans (i.e., enrolling employees by default unless they opt out). Automatic enrollment was further facilitated by the Pension Protection Act of 2006. In 401(k) plans, automatic enrollment has tended to increase participation rates to more than nine out of ten eligible employees. In contrast, for workers who lack access to a retirement plan at their workplace and are eligible to engage in tax-favored retirement saving by taking the initiative and making the decisions required to establish and contribute to an IRA, the IRA participation rate tends to be less than one out of ten.

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

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

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

### **Proposal**

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

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

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

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

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

Small employers (those that have no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable tax credit for the employer's expenses associated with the arrangement up to \$1,000 per year for three years. Furthermore, these employers would be entitled to an additional non-refundable credit of \$25 per enrolled employee up to \$250 per year for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (for example, because they have ten or fewer employees).

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

the expanded credit would encourage small employers to adopt a new 401(k), SIMPLE, or other employer plan and would not apply to automatic IRAs or other payroll deduction IRAs.

Lastly, small employers would be allowed a credit of \$500 per year for up to three years for new plans that include auto enrollment (which would be in addition to the “start-up costs” credit of up to \$1,500 per year). Small employers would also be allowed a credit of \$500 per year for up to three years if they added auto enrollment as a feature to an existing plan.

The proposal would become effective after December 31, 2016.

## **EXPAND PENALTY-FREE WITHDRAWALS FOR LONG-TERM UNEMPLOYED**

### **Current Law**

Early withdrawals from a tax-qualified retirement plan or IRA are subject to a 10-percent additional tax, unless an exception applies. An individual is eligible for an exception from the 10-percent additional tax with respect to a distribution from an IRA after separation from employment if (1) the individual has received unemployment compensation for 12 consecutive weeks by reason of the separation from employment, (2) the distribution is made during the taxable year in which the unemployment compensation is paid or in the succeeding taxable year, and (3) the aggregate of all such distributions does not exceed the premiums paid during the taxable year for health insurance. A distribution that is made after an individual has again been employed for at least 60 days is not eligible for this exception from the 10-percent additional tax. There is no corresponding exception from the 10-percent additional tax for distributions from a qualified retirement plan by reason of a period of unemployment.

The fair market value of an individual's IRA is reported to the IRS as of the end of each year on Form 5498. No similar reporting is required with respect to the fair market value of an individual's account balance in a tax-qualified defined contribution plan.

### **Reasons for Change**

Because unemployment compensation is available only for a limited period, some long-term unemployed individuals may have no choice but to take distributions from an IRA or tax-qualified retirement plan to pay for basic necessities for themselves and their families. Although the 10-percent additional tax is intended to deter individuals from using retirement savings for purposes other than retirement, imposing the additional tax on distributions to a long-term unemployed individual further erodes the limited resources available to the individual without having a substantial deterrent effect.

### **Proposal**

The proposal would expand the exception from the 10-percent additional tax to cover more distributions to long-term unemployed individuals from an IRA (in excess of the premiums paid for health insurance) and to include distributions to long-term unemployed individuals from a 401(k) or other tax-qualified defined contribution plan. An individual would be eligible for this expanded exception with respect to any distribution from an IRA, 401(k), or other tax-qualified defined contribution plan if (1) the individual has been unemployed for more than 26 weeks by reason of a separation from employment and has received unemployment compensation for that period (or, if less, for the maximum period for which unemployment compensation is available under State law applicable to the individual) (an eligible individual), (2) the distribution is made during the taxable year in which the unemployment compensation is paid or in the succeeding taxable year (which allows for distributions over the same two-year period applicable under current law), and (3) the aggregate of all such distributions does not exceed the annual limits described below.

To be eligible for the exception from the 10-percent additional tax, the aggregate of all such distributions received by an eligible individual from IRAs with respect to the separation from employment may not exceed half of the aggregate fair market value of the individual's IRAs (as of the end of the taxable year preceding the first distribution, as reported on the Form 5498 for each such IRA), and the aggregate of all such distributions received by the eligible individual from 401(k) or other tax-qualified defined contributions plans with respect to the separation from employment may not exceed half of the aggregate fair market value of the individual's nonforfeitable accrued benefits under those plans as of the date of the first distribution. However, an individual would in any event be eligible for this exception for the first \$10,000 of otherwise eligible distributions (even if that is greater than half of the aggregate fair market value of the individual's IRAs or nonforfeitable defined contribution plan benefits). Eligible distributions with respect to any separation from employment from all of an eligible individual's IRAs and tax-qualified defined contribution plans in the aggregate would be limited to a maximum of \$50,000 per year during each of the two years when distributions would be permitted under this exception, for a total of \$100,000 with respect to any single period of long-term unemployment.

A plan would be entitled to rely upon an individual's representation that the individual is an eligible individual in order to allow the plan administrator to separately track distributions that are entitled to the exception from the 10-percent additional tax. A new code would be added to the Form 1099-R for the administrator of a tax-qualified defined contribution plan to report a distribution that is eligible for this exception. No additional reporting would apply to an IRA trustee. There would be no need for the trustee to monitor compliance with the limit because the necessary reference information (the fair market value of the individual's IRAs) is already provided to the IRS as of the end of each taxable year.

The current exception from the 10-percent additional tax, for distributions up to the amount of health insurance premiums paid during the year after receiving unemployment compensation for 12 consecutive weeks, will still apply.

This proposal would apply to eligible distributions occurring after December 31, 2015.

## **REQUIRE RETIREMENT PLANS TO ALLOW LONG-TERM PART-TIME WORKERS TO PARTICIPATE**

### **Current Law**

A qualified retirement plan sponsor is permitted to delay covering employees until after they work at least 1,000 hours in a year. In other words, retirement plans are not required to cover employees working less than about half time. Also, if a sponsor provides for immediate vesting, it can delay covering employees until they work at least 1,000 hours in each of two years. However, this two-year eligibility rule cannot delay beyond one year an employee's eligibility to make section 401(k) elective contributions. Similar to the 1,000-hour threshold for coverage eligibility, employees also are not required to be credited with a year of service for purposes of vesting in employer contributions unless they work at least 1,000 hours in a year.

A qualified section 401(k) plan must benefit eligible employees in a way that does not discriminate in favor of highly compensated employees (HCEs). In particular, the amount HCEs can contribute is limited based on the amount non-HCEs contribute. In general, all eligible employees (and their contributions) count in applying this test. To encourage employers to cover employees earlier than required, the plan sponsor may apply the test separately for the group of "early entry" employees as distinct from other eligible employees.

### **Reasons for Change**

Part-time employees who work less than 1,000 hours each year can be permanently excluded not only from eligibility to participate in a qualified retirement plan and benefit from employer contributions but even from eligibility to make section 401(k) salary reduction contributions. Overall retirement savings could increase if more part-time employees were eligible at least to make section 401(k) salary reduction contributions under employer-sponsored plans, provided that the expansion was designed to avoid having the unintended effects of discouraging employers from sponsoring plans or prompting employers to limit hours or refrain from hiring part-time workers.

### **Proposal**

The proposal would require section 401(k) plans to expand eligibility to participate by permitting employees to make salary reduction contributions if the employee has worked at least 500 hours per year with the employer for at least three consecutive years. The proposal would not require expanded eligibility to receive employer contributions, including employer matching contributions. The three-year condition would help address the concern that part-time workers tend to change jobs frequently, after accumulating only small account balances that either are cashed out or, if left behind in the plan, can be costly to administer relative to the size of the balance. The proposal would also require a plan to credit, for each year in which such an employee worked at least 500 hours, a year of service for purposes of vesting in any employer contributions.



With respect to employees newly covered under the proposed change, employers would receive nondiscrimination testing relief (similar to current-law relief for plans covering otherwise excludable employees), including permission to exclude these employees from top-heavy vesting and top-heavy benefit requirements.

This proposal would apply to plan years beginning after December 31, 2015.

## **FACILITATE ANNUITY PORTABILITY**

### **Current Law**

A section 401(k) plan generally cannot distribute amounts attributable to an employee's elective contributions before (i) the employee's death, disability, severance from employment, attainment of age 59½, or hardship, or (ii) termination of the plan.

Distributions from a qualified retirement plan are subject to a 10-percent tax, in addition to any income or other applicable taxes, unless the distribution is (i) made on or after the employee has attained age 59½, (ii) made to a beneficiary on or after the death of the employee, (iii) attributable to the employee being disabled, (iv) part of a series of substantially equal periodic payments (made not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and a designated beneficiary, (v) made to an employee after separation from service after attaining age 55, (vi) a dividend paid with respect to certain employer securities held in an employee stock ownership plan, or (vii) made under certain other limited circumstances.

### **Reasons for Change**

In recent years, the Department of the Treasury has sought to reduce or eliminate impediments to offering lifetime income options, such as annuities, within 401(k) and other defined contribution retirement plans. For example, the Department of the Treasury has issued guidance permitting qualified longevity annuities in retirement plans and IRAs and providing relief under nondiscrimination rules to facilitate the inclusion of deferred annuities inside target date funds that are offered as a default investment in a section 401(k) plan.

Another impediment to offering annuities is a concern that employers making an accumulation annuity investment available within a plan do not have good options if the employer wants (or needs) to remove the annuity investment option from the plan (for example, because a new trustee or recordkeeper will not support the annuity investment or the annuity product is no longer available on favorable terms). In some cases, plans and participants may incur significant surrender charges or other penalties if the annuity investment option is discontinued.

### **Proposal**

The proposal would permit a plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the annuity investment is no longer authorized to be held under the plan, without regard to whether another event permitting a distribution (such as a severance from employment) has occurred. The distribution would not be subject to the 10-percent additional tax. By requiring the distribution to be accomplished through a direct rollover to an IRA or other retirement plan, the proposal would keep assets within the tax-favored retirement system to the extent possible.

The proposal would be effective for plan years beginning after December 31, 2015.

## **SIMPLIFY MINIMUM REQUIRED DISTRIBUTION (MRD) RULES**

### **Current Law**

The MRD rules generally require participants in tax-favored retirement plans, including qualified plans under section 401(a), section 401(k) cash or deferred arrangements, section 403(a) annuity plans, section 403(b) programs for public schools and charitable organizations, eligible deferred compensation plans under section 457(b), Simplified Employee Pensions (SEPs), and SIMPLE plans, as well as owners of IRAs, to begin receiving distributions shortly after attaining age 70½. The rules also generally require that these retirement assets be distributed to the plan participant or IRA owner (or their spouses or other beneficiaries), in accordance with regulations, over their life or a period based on their life expectancy (or the joint lives or life expectancies of the participant/owner and beneficiary).<sup>1</sup> The MRD rules apply not only to distributions during the lifetime of the participant/owner but also to distributions from a plan or IRA after the participant/owner's death.

While designated Roth accounts held in employer-sponsored plans are subject to the MRD rules during the life of the designated Roth account holder, Roth IRAs are not subject to these MRD rules during the life of the Roth IRA holder. The MRD rules do apply, however, to both Roth IRAs and designated Roth accounts after the death of the holder.

If a participant or account owner fails to take, in part or in full, the minimum required distribution for a year by the applicable deadline, the amount not withdrawn is subject to a 50-percent excise tax.

In addition, taxpayers age 70½ and older are prohibited from contributing to traditional IRAs (beginning with the year they turn 70½).

### **Reasons for Change**

The MRD rules are designed largely to prevent taxpayers from using for other purposes amounts that were accorded tax-favored treatment in order to provide financial security for the taxpayers during retirement. In particular, they are designed to prevent taxpayers from leaving these amounts to accumulate in tax-exempt arrangements for the benefit of the taxpayers' heirs. Under current law, however, the MRD rules also apply to millions of senior citizens who do not have large tax-favored retirement benefits to fall back on during retirement. The rules require these individuals to calculate the annual amount of their minimum required distributions, subject to the 50-percent excise tax for failure to withdraw a sufficient amount, even though they are highly unlikely to try to defer withdrawal and taxation of these benefits for estate planning purposes. Exempting those with modest balances from the rules would simplify tax compliance for millions of senior citizens without compromising important policy objectives. In addition, the

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<sup>1</sup> Participants in tax-favored retirement plans (excluding IRAs) other than owners of at least five percent of the business sponsoring the retirement plan may wait to begin distributions until the year of retirement, if that year is later than the year in which the participant reaches age 70½.

proposal permits these individuals greater flexibility in determining when and how rapidly to draw down their limited retirement savings.

While no tax is due on distributions from Roth accounts, Roth account-holders, like savers using traditional retirement accounts, continue to benefit from the accumulation of tax-free earnings as long as the funds are not withdrawn. Therefore it is reasonable to apply the same MRD and contribution rules to Roth IRAs, to support the purpose of the accounts in providing resources for retirement. In addition, because Roth accounts in employee plans are subject to the MRD rules during the life of designated Roth account holders, but Roth IRAs are not, individuals have a tax incentive to save outside of employer-sponsored plans (or to roll over amounts saved in employer-sponsored plans into Roth IRAs). However, setting aside these tax considerations, individuals may not be better off saving in IRAs than in employer-sponsored plans. For example, employer plans may provide greater fiduciary protections, lower fees and expenses, better investment options and protection from creditors and legal judgments.

### **Proposal**

The proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed \$100,000 (indexed for inflation after 2016) on a measurement date. However, benefits under qualified defined benefit pension plans that have already begun to be paid in life annuity form (including any form of life annuity, such as a joint and survivor annuity, a single life annuity, or a life annuity with a term certain) would be excluded in determining the dollar amount of the accumulations. The MRD requirements would phase in ratably for individuals with aggregate retirement benefits between \$100,000 and \$110,000. The initial measurement date for the dollar threshold would be the beginning of the calendar year in which the individual reaches age 70½ or, if earlier, in which the individual dies, with additional measurement dates occurring only at the beginning of the calendar year immediately following any calendar year in which the individual's IRAs or plans receive contributions, rollovers, or transfers of amounts that were not previously taken into account.

The proposal would also harmonize the application of the MRD requirements for holders of designated Roth accounts and of Roth IRAs by generally treating Roth IRAs in the same manner as all other tax-favored retirement accounts, i.e., requiring distributions to begin shortly after age 70½, without regard to whether amounts are held in designated Roth accounts or in Roth IRAs. In addition, individuals would not be permitted to make additional contributions to Roth IRAs after they reach age 70½.

The proposal would be effective for taxpayers attaining age 70½ on or after December 31, 2015 and for taxpayers who die on or after December 31, 2015 before attaining age 70½.

## **ALLOW ALL INHERITED PLAN AND IRA BALANCES TO BE ROLLED OVER WITHIN 60 DAYS**

### **Current Law**

Generally, assets can be moved from a tax-favored employer retirement plan or from an IRA into an IRA or into an eligible retirement plan without adverse tax consequences. This movement of assets can generally be accomplished through a direct rollover of a distribution, a 60-day rollover, or a direct trustee-to-trustee transfer that is not a distribution. However, not all of these methods are available with respect to assets of a plan or IRA account inherited by a non-spouse beneficiary.

In particular, when a participant in a tax-favored employer retirement plan dies before all assets in the plan have been distributed, a beneficiary who is a surviving spouse may roll over the assets, by direct rollover or 60-day rollover, into an IRA that is treated either as a spousal inherited IRA or as the surviving spouse's own IRA. A beneficiary who is not a surviving spouse, on the other hand, may roll over the assets into an IRA that is a non-spousal inherited IRA only by means of a direct rollover; a 60-day rollover is not available to a surviving non-spouse beneficiary.

Similarly, when the owner of an IRA dies before all assets in the IRA have been distributed, a surviving spouse beneficiary may elect to treat the assets as his or her own IRA or as a spousal inherited IRA. In addition, a surviving spouse beneficiary may roll over the assets into an IRA that is treated either as the surviving spouse's own IRA or as a spousal inherited IRA. A surviving non-spouse beneficiary, on the other hand, may treat the assets as a non-spousal inherited IRA, and may move the assets to another non-spousal inherited IRA only by means of a direct trustee-to-trustee transfer; rollovers from the deceased owner's IRA to another IRA are not available for a surviving non-spouse beneficiary.

### **Reasons for Change**

The rules that a surviving non-spouse beneficiary under a tax-favored employer retirement plan may roll over assets to an IRA only by means of a direct rollover and that a surviving non-spouse beneficiary under an IRA may move assets to a non-spousal inherited IRA only by means of a direct trustee-to-trustee transfer create traps for the unwary. These differences in rollover eligibility between surviving non-spouse beneficiaries and surviving spouse beneficiaries (and living participants) serve little purpose and generate confusion among plan and IRA administrators and beneficiaries. For example, IRA administrators often treat all transfers (whether or not an IRA account is a non-spousal inherited IRA) as rollovers, thereby causing confusion for individuals and the IRS. Similarly non-spouse beneficiaries may attempt to move assets to an inherited IRA by means of a 60-day rollover.

### **Proposal**

The proposal would expand the options that are available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited plan or IRA assets to

a non-spousal inherited IRA by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The proposal would be effective for distributions made after December 31, 2015.

## **EXPAND THE EARNED INCOME TAX CREDIT (EITC) FOR WORKERS WITHOUT QUALIFYING CHILDREN**

### **Current Law**

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

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a plateau (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit). The dollar thresholds are adjusted annually for inflation. In 2015, the credit is phased in at a rate of 7.65 percent on earnings up to about \$6,580, such that the maximum credit will be just over \$500. The credit is phased out at a rate of 7.65 percent on income in excess of \$8,240 (\$13,750 for married couples filing jointly). The credit is phased out completely at incomes of \$14,820 for unmarried taxpayers and \$20,330 for married couples filing jointly.

To be eligible for the EITC for workers without qualifying children, the taxpayer must be at least 25 years old and less than 65 years old. (In the case of married taxpayers filing jointly, the credit may be claimed if at least one spouse is over age 24 and less than age 65.) A taxpayer who may be claimed as a dependent or as a qualifying child by another taxpayer, including most college students, may not claim the EITC for workers without children.

There is no age limitation of the EITC for workers with qualifying children.

### **Reasons for Change**

The EITC for workers without children is relatively small and phases out at very low incomes. As such, it provides little or no assistance to individuals at or near the poverty line. For example, in 2016 a single worker without children who earned \$12,000 (a wage close to the poverty line), would be in the phase-out range and eligible for a credit of about \$230 and would receive a refund of about \$76 after subtracting his or her Federal income tax (and would pay nearly \$920 in Federal payroll taxes). A single individual working full-time at minimum wage would receive \$40 of EITC and face income tax liability of \$365 after subtracting his or her EITC. A larger EITC for workers without children would promote employment and reduce poverty for this group of workers.

The current age restrictions prevent young workers and older workers from claiming the EITC. As a result, young workers living independently from their families are unable to benefit from the antipoverty and work related effects of the EITC just when they are establishing the patterns of behavior that may persist throughout their working lives. The EITC, by increasing the effective wage, encourages additional work effort in the short run, which may in turn affect long-run labor force attachment and wages. The current age restriction on older workers is

inconsistent with recent increases in the full retirement age. As a result, workers age 65 and 66 with low incomes may lose the benefit of the EITC before retiring and claiming their social security benefits.

### **Proposal**

The proposal would increase the EITC for workers without qualifying children by doubling the phase-in rate and the phase-out rate from 7.65 percent to 15.3 percent, thereby doubling the maximum credit from about \$500 to about \$1,000. The beginning of the phase-out range would be increased from an estimated \$8,350 to \$11,500 for 2016 (from \$13,940 to \$17,090 for joint filers) and be indexed for inflation in subsequent years as under current law. Thus, the credit for workers without qualifying children would be phased out completely at \$18,173 for single taxpayers and \$23,763 for married taxpayers filing jointly.

The proposal would also allow taxpayers who are at least age 21 and under age 67 to claim the EITC for workers without qualifying children, if otherwise eligible. In the case of married taxpayers filing jointly, the credit could be claimed if either spouse were at least age 21 and under age 67. As under current law, taxpayers who could be claimed as a qualifying child or a dependent would not be eligible for the EITC for childless workers. Thus, full-time students who are dependent upon their parents would not be allowed to claim the EITC for workers without qualifying children, despite meeting the new age requirements, even if their parents did not claim a dependent exemption or an EITC on their behalf.

In addition, a separate proposal would simplify the EITC rules by allowing certain taxpayers who reside with a qualifying child that they do not claim to receive the EITC for workers without qualifying children.

This proposal would be effective for taxable years beginning after December 31, 2015.



## **SIMPLIFY THE RULES FOR CLAIMING THE EARNED INCOME TAX CREDIT (EITC) FOR WORKERS WITHOUT QUALIFYING CHILDREN**

### **Current Law**

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

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a plateau (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit). The EITC for workers without qualifying children is much smaller and phases out at a lower income level than does the EITC for workers with qualifying children.

In general, taxpayers with low wages who do not have any qualifying children may be eligible to claim the small EITC for workers without qualifying children. However, if the taxpayer resides with a qualifying child whom the taxpayer does not claim (perhaps because that child is claimed by another individual within the household), the taxpayer is not eligible for any EITC.

### **Reasons for Change**

Prohibiting a taxpayer who resides with a qualifying child whom the taxpayer does not claim from claiming the EITC for workers without qualifying children is confusing to taxpayers and difficult for the IRS to enforce. The prohibition is also inequitable and weakens the work incentives of the credit.

### **Proposal**

The proposal would allow otherwise eligible taxpayers residing with qualifying children whom they do not claim to receive the EITC for workers without qualifying children.

In addition, a separate proposal would expand the EITC for workers without qualifying children.

The proposal would be effective for taxable years beginning after December 31, 2015.

## PROVIDE A SECOND-EARNER TAX CREDIT

### Current Law

Married couples generally file their Federal income tax returns jointly by pooling income and deducting combined allowable expenses between both spouses. Married persons cannot choose single or head of household filing status. Married persons also can use the “married filing separately” status, but will usually face a higher tax liability as married filing separately than married filing jointly. The rate brackets for taxable income, which vary by filing status, for tax year 2015 are:

Rate	Single	Married Filing Jointly	Head of Household
10%	Not over \$9,225	Not over \$18,450	Not over \$13,150
15%	Over \$9,225 but not over \$37,450	Over \$18,450 but not over \$74,900	Over \$13,150 but not over \$50,200
25%	Over \$37,450 but not over \$90,750	Over \$74,900 but not over \$151,200	Over \$50,200 but not over \$129,600
28%	Over \$90,750 but not over \$189,300	Over \$151,200 but not over \$230,450	Over \$129,600 but not over \$209,850
33%	Over \$189,300 but not over \$411,500	Over \$230,450 but not over \$411,500	Over \$209,850 but not over \$411,500
35%	Over \$411,500 but not over \$413,200	Over \$411,500 but not over \$464,850	Over \$411,500 but not over \$439,000
39.6%	Over \$413,200	Over \$464,850	Over \$439,000

Under this rate structure, different segments of taxable income are taxed at different marginal tax rates, with the rates rising as taxable income increases.

A taxpayer’s effective marginal tax rate is also affected by other elements of the individual income tax. For example, phaseins and phaseouts of tax credits targeted to low- and moderate-income families decrease and increase, respectively, the effective marginal tax rate.

### Reasons for Change

About 60 percent of married-couple families between the ages of 25 and 64 will include two earners in 2016. By taxing the second (lower) earner’s income based on the couple’s joint income, the second earner can face higher marginal tax rates under the progressive tax system based on family income and can be discouraged from working. A credit for two-earner married couples would provide tax relief for working families and promote employment among second earners.

### Proposal

The proposal would provide two-earner married couples who file as married-filing-jointly a nonrefundable tax credit equal to a percentage of the lower earner’s earned income up to \$10,000. For purposes of this credit, earned income includes wages and net earnings from self-

employment. The credit rate would be five percent and would phase down at a rate of one-half of a percentage point for every \$10,000 of AGI over \$120,000. Therefore, the maximum credit would be \$500 and the credit would be fully phased out at AGI over \$210,000. The maximum creditable earned income (\$10,000) and the AGI at which the credit rate starts to phase down (\$120,000) would be indexed for inflation after 2016.

The proposal would be effective for taxable years beginning after December 31, 2015.

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

### **Current Law**

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness. Exceptions to this general rule include exclusions for debtors in Title 11 bankruptcy cases, for insolvent debtors, for discharges of certain farm and non-farm business indebtedness, and for discharges of qualified principal residence indebtedness (QPRI). Most of the exceptions require taxpayers to take steps (such as reducing basis) to merely defer the income from the discharge rather than excluding it permanently.

The amount of discharge generally is the excess of the adjusted issue price of the debt being discharged over the amount, if any, that the borrower uses to satisfy the debt. If a modification of indebtedness is treated as an exchange of an old debt instrument for a new one, then the amount of discharge is measured as the difference between the adjusted issue price of the old debt instrument and the issue price of the new debt instrument.

QPRI is acquisition indebtedness with respect to the taxpayer's principal residence (limited to \$2 million). Acquisition indebtedness with respect to a principal residence generally means indebtedness that is incurred in the acquisition, construction, or substantial improvement of the taxpayer's principal residence and that is secured by the residence. It also includes refinancing of preexisting acquisition indebtedness to the extent the amount of the new debt does not exceed the old. If, immediately before the discharge, only a portion of discharged indebtedness is QPRI, then the discharge is treated as applying first to the portion of the debt that is *not* QPRI, and thus the exclusion applies only to the extent that the total discharge was greater than that non-QPRI portion. The basis of the taxpayer's principal residence is reduced by the amount excluded from income under the provision.

The exclusion for discharges of QPRI was added to the Code by the Mortgage Forgiveness Debt Relief Act of 2007, effective for discharges in 2007 through 2009. The Emergency Economic Stabilization Act of 2008 extended the exclusion to discharges in 2010, 2011, and 2012. The American Taxpayer Relief Act of 2012 extended the exclusion through 2013. The Tax Increase Prevention Act of 2014 extended the exclusion through 2014.

### **Reasons for Change**

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

mortgage. Or, the homeowner and the holder may agree for the loan to be modified so that the homeowner can again become timely in making payments. Although there has been improvement in the residential real estate market, there is still an elevated number of cases in which homeowners may have discharge of indebtedness income with respect to their home mortgage loans.

Beyond the many modifications being made without Government assistance, large numbers of mortgage modifications are being made under the Treasury program Making Home Affordable, including the Home Affordable Modification Program<sup>®</sup> (HAMP<sup>®</sup>). Facilitating home mortgage modifications remains important for the continued recovery of the residential real estate market. The importance is demonstrated by the fact that HAMP<sup>®</sup> has been extended at least through the end of 2016. Also, many lenders have reached settlements with Federal and State authorities, which include terms committing lenders to engage in certain borrower-favorable conduct, and writing down mortgage loan principal in many instances counts toward meeting this requirement.

### **Proposal**

The exclusion for income from the discharge of QPRI would be extended to amounts that are discharged before January 1, 2018, and to amounts that are discharged pursuant to an arrangement entered into before that date.

# **REFORMS TO CAPITAL GAINS TAXATION, UPPER-INCOME TAX BENEFITS, AND THE TAXATION OF FINANCIAL INSTITUTIONS**

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

### **Current Law**

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

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

Individual taxpayers may elect to itemize their deductions instead of claiming a standard deduction. In general, itemized deductions include medical and dental expenses (in excess of 7.5 percent of AGI in 2015 for taxpayers age 65 or over and 10 percent of AGI for other taxpayers), State and local property taxes and income taxes, interest paid, gifts to charities, casualty and theft losses (in excess of 10 percent of AGI), job expenses and certain miscellaneous expenses (some only in excess of two percent of AGI).

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

### **Reasons for Change**

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

## **Proposal**

The proposal would limit the tax value of specified deductions or exclusions from AGI and all itemized deductions. This limitation would reduce the value to 28 percent of the specified exclusions and deductions that would otherwise reduce taxable income in the 33-percent, 35-percent, or 39.6-percent tax brackets. A similar limitation also would apply under the alternative minimum tax.

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

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

The proposal would be effective for taxable years beginning after December 31, 2015.

## **REFORM THE TAXATION OF CAPITAL INCOME**

### **Current Law**

Capital gains are taxable only upon the sale or other disposition of an appreciated asset. Most capital gains and dividends are taxed at graduated rates, with 20 percent generally being the highest rate. In addition, higher-income taxpayers are subject to a tax of 3.8 percent of the lesser of net investment income, including capital gains and dividends, or modified AGI in excess of \$200,000 (\$250,000 for married couples filing jointly and \$125,000 for married persons filing separately).

When a donor gives an appreciated asset to a donee during life, the donee's basis in the asset is its basis in the hands of the donor; there is no realization of capital gain by the donor at the time of the gift, and there is no recognition of capital gain by the donee until the donee later disposes of that asset. When an appreciated asset is held by a decedent at death, the decedent's heir receives a basis in that asset equal to its fair market value at the date of the decedent's death. As a result, the appreciation accruing during the decedent's life on assets that are still held by the decedent at death is never subjected to income tax.

### **Reasons for Change**

Preferential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers and provide many high-income taxpayers with a lower tax rate than many low- and middle-income taxpayers.

Because the person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value on the decedent's death, the appreciation that accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement must pay income tax on their realized capital gains. This increases the inequity in the tax treatment of capital gains. In addition, the preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

### **Proposal**

The proposal would increase the highest long-term capital gains and qualified dividend tax rate from 20 percent to 24.2 percent. The 3.8 percent net investment income tax would continue to apply as under current law. The maximum total capital gains and dividend tax rate including net investment income tax would thus rise to 28 percent.

Under the proposal, transfers of appreciated property generally would be treated as a sale of the property. The donor or deceased owner of an appreciated asset would realize a capital gain at the time the asset is given or bequeathed to another. The amount of the gain realized would be the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. That gain would be taxable income to the donor in the year the transfer was made, and to



the decedent either on the final individual return or on a separate capital gains return. The unlimited use of capital losses and carry-forwards would be allowed against ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any). Gifts or bequests to a spouse or to charity would carry the basis of the donor or decedent. Capital gain would not be realized until the spouse disposes of the asset or dies, and appreciated property donated or bequeathed to charity would be exempt from capital gains tax.

The proposal would exempt any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The proposal also would allow a \$100,000 per-person exclusion of other capital gains recognized by reason of death that would be indexed for inflation after 2016, and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively \$200,000 per couple). The \$250,000 per person exclusion under current law for capital gain on a principal residence would apply to all residences, and would also be portable to the decedent's surviving spouse (making the exclusion effectively \$500,000 per couple).

The exclusion under current law for capital gain on certain small business stock would also apply. In addition, payment of tax on the appreciation of certain small family-owned and family-operated businesses would not be due until the business is sold or ceases to be family-owned and operated. The proposal would further allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.

The proposal also would include other legislative changes designed to facilitate and implement this proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; and a broad grant of regulatory authority to provide implementing rules.

To facilitate the transition to taxing gains at death and gift, the Secretary would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable.

This proposal would be effective for capital gains realized and qualified dividends received in taxable years beginning after December 31, 2015, and for gains on gifts made and of decedents dying after December 31, 2015.

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

### **Current Law**

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

Qualified dividends and long-term capital gains are taxed at a maximum rate of 23.8 percent, while ordinary income, including wages, is taxed at graduated rates that rise as high as 39.6 percent. In addition, wages and self-employment earnings are subject to payroll taxes as high as 15.3 percent (7.65 percent each for employee and employer), but average and marginal payroll tax rates are much lower for higher-income families, because the wage base for much of the payroll tax is capped at \$118,500 in 2015.

### **Reasons for Change**

Deductions can significantly reduce tax liability for high-income taxpayers. For example, under current law, almost eight percent of itemized deductions would accrue to the top 0.1 percent of families in 2015. Higher-income families also face lower payroll average tax rates than do middle income families.

In addition, many high-income taxpayers derive large benefits from the preferentially low tax rates on dividends and capital gains. For example, nearly 90 percent of families in the top 0.1 percent of the income distribution benefit from the lower tax rate on dividends and capital gains, compared to less than 10 percent of families in the bottom 60 percent of the income distribution. High-income investors, who have large amounts of dividends and capital gains, can have tax burdens that are much lower than those paid by equally well-off high-income workers. In addition, the maximum 23.8-percent tax rate on dividends and capital gains (inclusive of the 3.8 percent net investment income tax) is below the statutory tax rates on wages faced by many families with moderate incomes. Consequently, a high-income taxpayer whose income is largely derived from capital gains or dividend income may have a lower average tax rate than a taxpayer with less income whose income is largely or exclusively derived from wages.

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

In a separate proposal, the Administration proposes to increase the top long-term capital gains and qualified dividends tax rate from 20 percent to 24.2 percent. Including the 3.8 percent tax on net investment income, this would increase the top effective long-term capital gains and qualified dividends tax rate to 28 percent. Although this tax rate increase would reduce the effect of the Buffett Rule, the Rule would still be needed to address tax inequities.

## **Proposal**

The proposal would impose a new minimum tax, called the Fair Share Tax (FST), on high-income taxpayers. The tentative FST would equal 30 percent of AGI less a credit for charitable contributions. The charitable credit would equal 28 percent of itemized charitable contributions allowed after the overall limitation on itemized deductions (so called Pease limitation). The final FST would be the excess, if any, of the tentative FST over the sum of the taxpayer's (1) regular income tax (after certain credits) including the 3.8-percent net investment income tax, (2) the alternative minimum tax, and (3) the employee portion of payroll taxes. The set of certain credits subtracted from regular income tax would exclude the foreign tax credit, the credit for tax withheld on wages, and the credit for certain uses of gasoline and special fuels.

The amount of FST payable (i.e., the excess of tentative FST over regular tax) would be phased in linearly starting at \$1 million of AGI (\$500,000 in the case of a married individual filing a separate return). The FST would be fully phased in at \$2 million of AGI (\$1 million in the case of a married individual filing a separate return). For example, if a single taxpayer had AGI of \$1.25 million, tentative FST of \$375,000 and regular tax of \$250,000, his payable FST would be  $((\$1.25 \text{ million} - \$1 \text{ million}) / (\$2 \text{ million} - \$1 \text{ million})) \times (\$375,000 - \$250,000) = \$31,250$ . The AGI thresholds would be indexed for inflation beginning after 2016.

The proposal would be effective for taxable years beginning after December 31, 2015.

## **IMPOSE A FINANCIAL FEE**

### **Current Law**

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

### **Reasons for Change**

Excessive risk undertaken by major financial firms was a significant cause of the recent financial crisis and an ongoing potential risk to macroeconomic stability. The financial fee is designed to reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.

### **Proposal**

The Administration proposes to assess a financial fee on certain liabilities of large firms in the financial sector. Specific components of the proposal are described below.

The fee would apply to banks, both U.S. and foreign, and would also apply to bank holding companies, and “nonbanks,” such as insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. Firms with worldwide consolidated assets of less than \$50 billion would not be subject to the fee for the period when their assets are below this threshold. U.S. subsidiaries and branches of foreign entities that fall into these business categories and that have assets in excess of \$50 billion also would be covered.

The fee would apply to the covered liabilities of a financial entity. Covered liabilities are assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts (primarily for insurance companies).

The rate of the fee applied to covered liabilities would be seven basis points.

The fee would be deductible in computing corporate income tax.

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

The fee would be effective as of January 1, 2016.

## **LOOPHOLE CLOSERS**

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

#### **Current Law**

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

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

#### **Reasons for Change**

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

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

#### **Proposal**

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

The proposal would apply to debt securities acquired after December 31, 2015.

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

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would apply to portfolio stock acquired after December 31, 2015.

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

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

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

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

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

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

The proposal would be effective for taxable years ending after December 31, 2015.



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

### **Current Law**

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

Minimum distribution rules also apply to balances remaining after a plan participant or IRA owner has died. The after-death rules vary depending on (1) whether a participant or IRA owner dies on or after the required beginning date or before the required beginning date, and (2) whether there is an individual designated as a beneficiary under the plan. The rules also vary depending on whether the participant's or IRA owner's spouse is the sole designated beneficiary.

If a plan participant or IRA owner dies on or after the required beginning date and there is a non-spouse individual designated as beneficiary, the distribution period is the beneficiary's life expectancy, calculated in the year after the year of death. The distribution period for later years is determined by subtracting one year from the initial distribution period for each year that elapses. If there is no individual designated as beneficiary, the distribution period is equal to the expected remaining years of the participant's or IRA owner's life, calculated as of the year of death.

If a participant or IRA owner dies before the required beginning date and any portion of the benefit is payable to a non-spouse designated beneficiary, distributions must either begin within one year of the participant's or IRA owner's death and be paid over the life or life expectancy of the designated beneficiary or be paid entirely by the end of the fifth year after the year of death.

If the designated beneficiary dies during the distribution period, distributions continue to any subsequent beneficiaries over the remaining years in the distribution period.

If a participant or IRA owner dies before the required beginning date and there is no individual designated as beneficiary, then the entire remaining interest of the participant or IRA owner must generally be distributed by the end of the fifth year following the individual's death.

The minimum distribution rules do not apply to Roth IRAs during the life of the account owner, but do apply to balances remaining after the death of the owner.

## **Reasons for Change**

The Code gives tax preferences for retirement savings accounts primarily to provide retirement security for individuals and their spouses. The preferences were not created with the intent of providing tax preferences to the non-spouse heirs of individuals. Because the beneficiary of an inherited account can be much younger than a plan participant or IRA owner, the current rules allowing such a beneficiary to stretch the receipt of distributions over many years permit the beneficiary to enjoy tax-favored accumulation of earnings over long periods of time.

## **Proposal**

Under the proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries.

Eligible beneficiaries include any beneficiary who, as of the date of death, is disabled, a chronically ill individual, an individual who is not more than 10 years younger than the participant or IRA owner, or a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner. However, in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

Any balance remaining after the death of a beneficiary (including an eligible beneficiary excepted from the five-year rule or a spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death.

The proposal would be effective for distributions with respect to plan participants or IRA owners who die after December 31, 2015. The requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death would also apply to participants or IRA owners who die before January 1, 2015, but only if the beneficiary dies after December 31, 2015. The proposal would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

## **LIMIT THE TOTAL ACCRUAL OF TAX-FAVORED RETIREMENT BENEFITS**

### **Current Law**

Under current law, the maximum benefit permitted to be paid under a qualified defined benefit plan in 2015 is generally \$210,000 per year and is adjusted for increases in the cost of living. The maximum benefit limit is reduced if distributions begin before age 62 and is increased if distributions begin after age 65. The maximum benefit is also adjusted if it is paid in a form other than a straight life annuity or a qualified joint and survivor annuity.

For a defined contribution plan, current law limits the amount of annual contributions or other additions to the account and applies a separate limit to elective deferrals made by taxpayers to the plan, but does not limit the amount that can be accumulated within the account. For 2015, the annual contribution limit is \$53,000, and the elective deferral limit is \$18,000. Each of these limits is adjusted for increases in the cost of living, and each limit is increased by \$6,000 for taxpayers who are 50 or over. Similarly, current law limits the amount of the annual contribution to an IRA, but does not limit the amount that can be accumulated within the IRA. The annual contribution limit for 2015 is \$5,500 (adjusted for changes in the cost of living) with an additional \$1,000 for taxpayers who are 50 or over.

While the limitations on the extent to which a taxpayer can make contributions to an IRA are applied based on aggregating all of the taxpayer's IRAs, the limitations on accruals under defined benefit plans and the limitations on contributions under defined contribution plans are not applied by aggregating all such arrangements. Instead, the aggregation is applied solely for multiple plans sponsored by the same employer or related employers, and for this purpose defined benefit plans are not aggregated with defined contribution plans. (Under a combined limit that was in effect from 1976 to 1996, an individual's projected benefits under defined benefit plans were combined with the individual's cumulative contributions under defined contribution plans maintained by the same employer). Furthermore, there is no aggregation for plans that are sponsored by unrelated employers and no coordination between the contribution limits that apply to IRAs and the limits that apply to plans. However, the Tax Reform Act of 1986 imposed an excise tax on excess distributions (and accumulations remaining at death in excess of approximately \$1 million) from (or accumulated in) all qualified plans in which a taxpayer participated (including both defined contribution and defined benefit plans and both related and unrelated employers) and all of the taxpayer's IRAs. The excise tax was repealed in 1997.

Under current law, the annual limit on elective deferrals for a plan also serves as an overall limit on elective deferrals for a taxpayer who participates in 401(k) plans sponsored by unrelated employers. If a taxpayer's aggregate elective deferrals for a year exceed the limit for the year, the taxpayer must include the excess in income for the year of the excess deferral. A grace period is provided to allow taxpayers the opportunity to remove the excess deferrals. If the taxpayer fails to avail him or herself of this grace period and leaves the excess deferrals in the 401(k) account, then the excess deferrals and attributable earnings will be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a designated Roth account within a plan).

## **Reasons for Change**

The current law limitations on retirement contributions and benefits for each plan in which a taxpayer may participate do not adequately limit the extent to which a taxpayer can accumulate amounts in a tax-favored arrangement through the use of multiple plans. Such accumulations can be considerably in excess of amounts needed to fund reasonable levels of consumption in retirement and are well beyond the level of accumulation that justifies tax-advantaged treatment of retirement savings accounts. Requiring a taxpayer who, in the aggregate, has accumulated very large amounts within the tax-favored retirement system to discontinue adding to those accumulations would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels, while still providing substantial tax incentives for reasonable levels of retirement saving.

## **Proposal**

A taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of \$210,000) 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 participant and, if longer, the life of a spouse, assumed to be of the same age would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 is approximately \$3.4 million.

The limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at 62, in the form of a 100-percent joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, where actuarial equivalence is determined by treating the individual as if he or she was still 62. In either case, the maximum permitted accumulation would continue to be adjusted for cost of living increases. Plan sponsors of defined benefit plans would generally report the amount of the accrued benefit and the accrual for the year, payable in the same form. Regulations would provide for simplified reporting for defined benefit plans. As one example, a sponsor of a cash balance plan would be permitted to treat a participant's hypothetical account balance under the plan as an accumulated account balance under a defined contribution plan for purposes of reporting under this provision. It is anticipated that other simplifications would be considered in order to ease administration.

If a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer's investment return for a year was less than the rate of return

built into the actuarial equivalence calculation (so that the updated calculation of the equivalent annuity is less than the maximum annuity for a tax-qualified defined benefit plan), there would be room to make additional contributions. In addition, when the maximum defined benefit level increases as a result of the cost-of-living adjustment, the maximum permitted accumulation will automatically increase as well. This also could allow a resumption of contributions for a taxpayer who previously was subject to a suspension of contributions by reason of the overall limitation.

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).

The proposal would be effective with respect to contributions and accruals for taxable years beginning after December 31, 2015.

## **CONFORM SELF-EMPLOYMENT CONTRIBUTIONS ACT (SECA) TAXES FOR PROFESSIONAL SERVICE BUSINESSES**

### **Current Law**

Social Security and Medicare benefits are financed via taxes on wages and self-employment earnings. Wages are subject to Federal Insurance Contribution Act (FICA) taxes while individuals' self-employment earnings are subject to SECA taxes. Both FICA taxes and SECA taxes apply in full (at a 15.3-percent rate) to employment earnings up to a threshold (e.g., \$117,000 in 2014) and at a reduced rate of 2.9 percent on employment earnings above that threshold. The tax on employment earnings above the threshold is devoted to funding Medicare. The Affordable Care Act (ACA) imposed an additional 0.9-percent Medicare tax on wages and self-employment earnings of high income taxpayers.

General partners and sole proprietors typically pay SECA taxes on the full amount of their net trade or business income. Limited partners pay SECA taxes only on the fairly narrow category of payments from the partnership that are for services provided and that are determined without regard to the income of the partnership. The application of SECA taxes to members of most limited liability companies (LLCs) is unclear because LLC members are neither general partners nor limited partners under State law. S corporation shareholders are not subject to SECA taxes. Instead, they are subject to FICA taxes on wages paid for services like any other employee.

Nonwage distributions to employee-shareholders of S corporations are not subject to either FICA or SECA taxes, although the IRS may reclassify such distributions as wages to the extent that any wages paid do not represent reasonable compensation for services provided by the employee-shareholder.

The ACA imposed a 3.8-percent net investment income tax (NIIT) for certain high income earners. The NIIT applies to investment income of individuals whose income exceeds a threshold, including passive income from partnerships and S corporations. The distributive share of trade or business income of active S corporation owners and active partners generally is not subject to the 3.8-percent NIIT.

### **Reasons for Change**

The taxation of employment income earned by owners of pass-through entities is outdated, unfair, and inefficient. It treats business owners differently according to the legal form of their ownership and the legal form of the payment that they receive. In part, this is a hold-over from earlier years when limited partners were prohibited by State law from holding managerial roles in their firms and LLCs did not exist. The differential treatment distorts choice of organizational form and provides tax planning opportunities for business owners, e.g., by some S corporation owners who receive substantial income in the form of distributions rather than as wages. As a result of these differences, some business owners pay employment taxes on nearly all their earnings (general partners and sole proprietors), other similarly situated owners pay employment taxes on only a portion of their earnings (S corporation owner-employees), and others pay little employment tax at all (limited partners and many LLC members). Thus, many owners of pass-

through entities successfully avoid payroll tax on income that is equivalent to self-employment earnings and that would be subject to employment taxes if the business had a different legal structure.

High income owners of most businesses are subject either to the NIIT or to FICA/SECA on income from that business. However, active owners of S corporations and partnerships are not subject to the NIIT on their shares of income from those entities. Because active S corporation owners and certain active partners are not subject to SECA, high income owners of businesses conducted in these forms may be subject to neither the NIIT nor FICA/SECA taxes. Conforming SECA taxes for professional service businesses will close this unintended gap between the application of the NIIT and FICA/SECA taxes for such businesses.

The current system is also a challenge for the IRS to administer. The determination of “reasonable compensation” of S corporation owners generally depends on facts and circumstances and requires a valuation analysis, so this requirement is difficult for the IRS to enforce. The uncertainty surrounding the treatment of LLC members undermines the IRS’s ability to ensure payment of SECA. As a result, small business owners’ avoidance of employment taxes presents a serious enforcement challenge for the IRS.

The problems in appropriately subjecting the income earned by owners of pass-through businesses to employment taxes seems most obvious and most severe where the income derives primarily from services provided by these owners.

### **Proposal**

Individual owners of professional service businesses organized as S corporations, limited partnerships, general partnerships, and LLCs taxed as partnerships would all be treated as subject to SECA taxes in the same manner and to the same degree. Owners providing services who materially participate would be subject to SECA taxes on their distributive shares of partnership (or LLC or S corporation) income. The exemptions provided under current law for certain types of partnership income (e.g., rents, dividends, capital gains, and certain retired partner income) would apply to professional service business organized as S corporations and LLC, in addition to those organized as partnerships. Owners who do not materially participate would be subject to SECA taxes only on an amount of income equal to reasonable compensation, if any, for services provided to the business. (“Reasonable compensation” would be as large as any guaranteed payments received from the business for their services.) Distributions of compensation to owners of professional service S corporations would no longer be treated as wages subject to FICA taxes but would be included in earnings subject to SECA taxes.

Material participation standards would apply to individuals who participate in a business in which they have a direct or indirect ownership interest. Taxpayers are generally considered to materially participate in a business if they are involved in a regular, continuous, and substantial way. Often this means they work for the business for at least 500 hours per year. Material participation would generally be determined as under the passive activity loss rules and associated regulations, except that the limited partner exception would not apply in the SECA context.

“Professional service businesses” would be defined as partnerships, S corporations, or other entities taxed as partnerships substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting (fields similar to those referenced in section 448(d)(2)(A)), as well as athletics, investment advice or management, brokerage services, and lobbying.

Treasury would have authority to issue regulations to implement the legislation.

This proposal would be effective for taxable years beginning after December 31, 2015.



## **LIMIT ROTH CONVERSIONS TO PRE-TAX DOLLARS**

### **Current Law**

A taxpayer is permitted to make a contribution to a Roth IRA only if the taxpayer's modified adjusted gross income (MAGI) is less than a specified limit that is indexed for inflation. For 2015, a married taxpayer filing a joint return is permitted to make a full contribution if the taxpayer's MAGI is less than \$183,000 and the contribution limit is phased out over the range of \$183,000 to \$193,000. An unmarried taxpayer is permitted to make a full contribution if the taxpayer's MAGI is less than \$116,000 and the contribution limit is phased out over the range of \$116,000 to \$131,000. No income limit applies to the ability to make contributions to a traditional IRA (although there is an income limit applicable for the deductibility of those contributions in the case of a taxpayer who is an active participant in a workplace retirement plan or who has a spouse who is an active participant).

A taxpayer can elect to convert amounts held in a traditional IRA to a Roth IRA by re-designating the IRA as a Roth IRA or by distributing the amount and then rolling it over into a Roth account. A taxpayer who converts an amount held in a traditional IRA must include the converted amount in income to the same extent it would be includible in income if distributed and not rolled over. That is, the amount is includible in income to the extent it is not a return of basis. A taxpayer can also roll over an amount held in an eligible retirement plan – such as a qualified plan – into a Roth IRA. If the distribution is not from a designated Roth account, the rollover to the Roth IRA is treated as a conversion and includible in the taxpayer's income to the extent it does not represent a return of basis.

### **Reasons for Change**

Some taxpayers who are not eligible to make contributions to Roth IRAs because their modified AGI exceeds the limit for such contributions have indirectly made contributions to a Roth IRA by making nondeductible contributions to a traditional IRA and then converting the traditional IRA to a Roth IRA.

### **Proposal**

The proposal would permit amounts held in a traditional IRA to be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the extent a distribution of those amounts would be includable in income if they were not rolled over. Thus, after-tax amounts (those attributable to basis) held in a traditional IRA could not be converted to Roth amounts. A similar rule would apply to amounts held in eligible retirement plans.

The proposal would apply to distributions occurring after December 31, 2015.

## **ELIMINATE DEDUCTION FOR DIVIDENDS ON STOCK OF PUBLICLY-TRADED CORPORATIONS HELD IN EMPLOYEE STOCK OWNERSHIP PLANS**

### **Current Law**

Generally, corporations do not receive an income tax deduction for dividends paid to their shareholders. However, a deduction for dividends paid with respect to employer stock held in an employee stock ownership plan (ESOP) is allowed if certain conditions are met. The deduction is available even if the ESOP is merely an “ESOP account” that is one of the investment options available to employees under a section 401(k) plan (which holds salary reduction contributions elected by employees and, often, contributions that match those elective contributions). In addition, the special deduction is available regardless of the extent of the ESOP’s ownership interest in the corporation.

To be deductible, the dividend paid must be an “applicable dividend.” A dividend qualifies as an applicable dividend only if the dividend is paid or used in accordance with one of four available alternatives. Specifically, a dividend qualifies as an applicable dividend if the dividend is (i) paid directly to the plan’s participants or their beneficiaries, (ii) paid to the plan and distributed to participants or their beneficiaries not later than 90 days after the end of the plan year, or (iii) at the election of the participants or their beneficiaries, could be paid either as described in (i) or (ii). Additionally, a dividend qualifies as an applicable dividend if it is used to repay a loan originally used to purchase the stock with respect to which the dividend is paid. For this purpose, the dividend qualifies as an applicable dividend only to the extent that employer securities with a fair market value of not less than the amount of the dividend are allocated to the accounts to which the dividend would have been allocated. The limitation on deductibility of dividends used to repay loans to those paid with respect to stock acquired with those loans does not apply to employer securities acquired by an ESOP prior to August 4, 1989 (if the plan was an ESOP prior to that date).

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

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

## **Reasons for Change**

Current law extends several tax benefits to ESOPs that are in addition to those applicable to other tax-qualified retirement plans. The ESOP dividend deduction is one of these benefits. Thus, while current law generally does not allow a paying corporation a deduction for dividends paid with respect to its stock, including stock that is held in a retirement plan, the deduction for dividends on employer stock held in an ESOP is an exception to this rule. The difference in treatment creates an additional incentive for employers to encourage investment in employer stock through ESOPs. However, concentration of employees' retirement savings in the stock of the employees' employer entails a risk that poor corporate performance or other factors will lead to a loss in value of the stock and hence of employees' retirement savings (which is the same risk that could also affect their job security) without necessarily offering a commensurate return.

Providing special tax benefits for ESOPs, including the tax deduction for current payments of dividends to ESOP participants, has been justified as encouraging employee ownership, which in turn has been viewed as having a productivity incentive effect, but this effect is more likely for employers that have a significant degree of employee ownership, where there may be a greater possibility that the benefits of any such incentives could justify the risks associated with the concentration of retirement savings in employer stock. Ownership of stock of a publicly traded corporation through an ESOP seems unlikely to offer significant productivity incentives to employees because their aggregate ownership interests in the corporation are more likely to be small relative to the ownership interests of public shareholders. Instead, in the context of publicly held corporations, the special dividend deduction for stock held in ESOPs has frequently served to encourage 401(k) plan sponsors to amend an existing employer stock fund investment option in a 401(k) plan to constitute an ESOP in order to benefit from the dividend deduction without significant changes in the character of the account or the extent of employee ownership. By eliminating the ESOP dividend deduction for dividends on employer stock of a publicly traded corporation held in an ESOP, the proposal seeks to strike a balance between the competing policy considerations.

## **Proposal**

The proposal would repeal the deduction for dividends paid with respect to employer stock held by an ESOP that is sponsored by a publicly traded corporation. Rules allowing for immediate payment of an applicable dividend would continue as would rules permitting the use of an applicable dividend to repay a loan used to purchase the stock of the publicly traded corporation. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

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

## **REPEAL EXCLUSION OF NET UNREALIZED APPRECIATION IN EMPLOYER SECURITIES**

### **Current Law**

In the case of a distribution of employer stock received as part of a lump-sum distribution from a tax-qualified retirement plan, the amount of net unrealized appreciation in the employer stock can be excluded from gross income in the year of the distribution. In the case of any other distribution (except a distribution that is not currently taxable under the rollover rules), the net unrealized appreciation in the employer stock generally can be excluded from gross income in the year of the distribution only to the extent that it is attributable to employee contributions. For this purpose, a distribution is a lump-sum distribution only if it is part of the distribution or payment within one taxable year of the recipient of the balance to the credit of a participant's account in a tax-qualified retirement plan that becomes payable to the recipient (1) on account of the participant's death, (2) after the participant attains age 59½, (3) on account of the participant's separation from service, or (4) after the participant has become disabled.

Net unrealized appreciation is the excess of the market value of employer stock at the time of distribution over the cost or other basis of that stock to the trust. Net unrealized appreciation is generally taxed as a capital gain at the time the employer stock is ultimately sold by the recipient.

### **Reasons for Change**

Current law extends several tax benefits to ESOPs and to participants in ESOPs and other plans that hold employer stock. These are in addition to the tax benefits applicable to other tax-qualified retirement plans. The exclusion of net unrealized appreciation in employer securities from gross income in the year of a distribution is one of these benefits. The special tax benefits create an additional incentive for employees to invest in employer stock through tax-qualified retirement plans. Concentration of employees' retirement savings in the stock of the company for which they work, however, subjects employees' retirement benefits to increased risk (potentially the same risk that could affect their job security) without necessarily offering a commensurate return.

### **Proposal**

The proposal would repeal the exclusion of net unrealized appreciation in employer stock in the year of a distribution for participants in tax-qualified retirement plans who have not yet attained age 50 as of December 31, 2015. Participants who have attained age 50 on or before December 31, 2015 would not be affected by the proposal.

The proposal would apply to distributions made after December 31, 2015.

## **DISALLOW THE DEDUCTION FOR CHARITABLE CONTRIBUTIONS THAT ARE A PREREQUISITE FOR PURCHASING TICKETS TO COLLEGE SPORTING EVENTS**

### **Current Law**

Under current law, donors who receive benefits in exchange for their contribution must reduce the value of their charitable contribution deduction by the fair market value of the benefits they receive. However, the law currently provides that donors to colleges and universities that receive in exchange for their contributions the right to purchase tickets for seating at an athletic event may deduct 80 percent of the contribution.

### **Reasons for Change**

Some colleges and universities give exclusive or priority purchasing privileges for sports ticket sales to donors, with the priority often dependent on the size of the gift. Donors may deduct 80 percent of the contribution, even when the value of the right to purchase tickets is far in excess of 20 percent of the contributed amount.

### **Proposal**

The proposal would deny the deduction for contributions that entitle donors to a right to purchase tickets to sporting events.

The proposal would be effective for contributions made in taxable years beginning after December 31, 2015.

## **INCENTIVES FOR JOB CREATION, CLEAN ENERGY, AND MANUFACTURING**

### **DESIGNATE PROMISE ZONES**

#### **Current Law**

The Code contains various incentives targeted to encourage the development of particular geographic regions, including empowerment zones. There are 40 empowerment zones – 30 in urban areas and 10 in rural areas – that were designated through a competitive application process in three separate rounds in 1994, 1998, and 2002. State and local governments nominated distressed geographic areas, which were selected on the strength of their strategic plans for economic and social revitalization. The urban areas were designated by the Secretary of Housing and Urban Development. The rural areas were designated by the Secretary of Agriculture. Empowerment zone designation remained in effect through December 31, 2014.

Incentives for businesses in empowerment zones include (1) a 20-percent wage credit for qualifying wages, (2) additional expensing for qualified zone property, (3) tax-exempt financing for certain qualifying zone facilities, (4) deferral of capital gains on sales and reinvestment in empowerment zone assets, and (5) exclusion of 60 percent (rather than 50 percent) of the gain on the sale of qualified small business stock held more than five years. (For qualified small business stock acquired after September 27, 2010 and before January 1, 2015, the exclusion percentage increases to 100 percent. This provision (100-percent exclusion) applies to all qualified small business stock, not just that issued by enterprise zone businesses.)

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

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

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

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

### **Reasons for Change**

Promise zones would promote job creation and investment in economically distressed areas that have demonstrated potential for future growth and diversification into new industries. While current law provides regionally targeted benefits to numerous areas, most of these incentives expired recently and some of these designations have been in effect for around 20 years. The Administration desires to target resources to areas where they would provide the most benefit on a going-forward basis. In particular, the national competition for promise zone status would encourage such areas to develop rigorous plans for economic growth that connect the zone to drivers of regional economic growth. The targeted tax incentives provided to the zone would encourage private sector investment and other forms of increased economic activity in these areas. The current tax incentives are perceived as complex and difficult for businesses to navigate, potentially reducing the take-up rate for these incentives.

### **Proposal**

The Administration proposes to designate 20 promise zones (14 in urban areas and 6 in rural areas), including zones that competed for and received a Promise Zone designation in 2014 and 2015. Zone designations for the purpose of the tax incentives would be in effect from January 1, 2016 through December 31, 2025. The Secretary of Agriculture and the Secretary of Housing and Urban Development (HUD) would select the zones in consultation with the Secretary of Commerce, the Secretary of Education, the Attorney General, the Secretary of Health and Human Services, the Secretary of Labor, and the Secretary of the Treasury.

The zones would be chosen through a competitive application process, inclusive of zones that were awarded Promise Zone designation in 2014 and 2015. To apply, an applicant would need the formal support of a State, county, city, or other general purpose political subdivision of a State or possession (a “local government”), or an Indian tribal government. Applicant areas could be supported by more than one local government, if the applicant area is within the jurisdiction of more than one local government or State. In addition, local governments within a region could join together to jointly support multiple applicant areas for promise zone status, so long as each designated zone independently satisfies the eligibility criteria. To be eligible to apply, an area must satisfy the following criteria:

1. An applicant area would have to have a continuous boundary (that is, an area must be a single area; it cannot be comprised of two or more separate areas).
2. The population of an applicant area could not exceed 200,000.

3. An applicant urban area would have to include a portion of at least one local government jurisdiction with a population of at least 50,000.

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

In evaluating applications, the Secretary of Agriculture and the Secretary of HUD could consider other factors for the affected population, including: unemployment rates, poverty rates, household income, home-ownership, labor force participation and educational attainment. In addition, the Secretary may set minimal standards for the levels of unemployment and poverty that must be satisfied by the nominated applicant area.

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

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

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

The Secretary of the Treasury would be given authority to collect data from taxpayers on the use of such tax incentives by zone. The Secretary of Agriculture and the Secretary of HUD may require the nominating local government to provide other data on the economic conditions in the



zones both before and after designation. These data would be used to evaluate the effectiveness of the promise zones program.

The proposal would be effective upon date of enactment.

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

### **Current Law**

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

### **Reasons for Change**

The President is proposing increased investment in research and development and a competitive program to encourage communities to invest in the advanced vehicle infrastructure, address the regulatory barriers, and provide the local incentives to achieve deployment at critical mass. The President is also proposing a transformation of the existing tax credit for plug-in electric drive motor vehicles into one that is allowed for a wider range of advanced technologies and that is allowed generally to the seller.

Making the credit available to a wider range of technologies, removing the cap placed on the number of vehicles per manufacturer that can receive the credit, and allowing for a scalable credit up to a maximum of \$10,000 will help increase production of advanced vehicles that diversify our fuel use and bring down the cost of producing such vehicles.

Making the credit transferable will add flexibility to the market. This flexibility would enable the seller or person financing the sale to offer a point-of-sale rebate to consumers.

### **Proposal**

The proposal would replace the credit for plug-in electric drive motor vehicles with a credit for advanced technology vehicles. The credit would be available for a vehicle that meets the following criteria: (1) the vehicle operates primarily on an alternative to petroleum; (2) as of January 1, 2014, there are few vehicles in operation in the U.S. using the same technology as such vehicle; and (3) the technology used by the vehicle exceeds the footprint based target miles per gallon by at least 25 percent. The Secretary of the Treasury, in consultation with the

Secretary of Energy, will determine what constitutes the “same technology” for this purpose. The credit would be limited to vehicles that weigh no more than 14,000 pounds and are treated as motor vehicles for purposes of Title II of the Clean Air Act. In general, the credit would be the sum of \$5,000 and the product of 100 and the amount by which the vehicle’s miles per gallon equivalent exceeds its footprint-based target miles per gallon, but would be capped at \$10,000 (\$7,500 for vehicles with an MSRP above \$45,000). The credit for a battery-powered vehicle would be determined under current law rules for the credit for plug-in electric drive motor vehicles if that computation results in a greater credit. The credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle or to the end-use purchaser of the vehicle. If the credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after December 31, 2015 and before January 1, 2023. The credit would be 75 percent of the otherwise allowable amount for vehicles placed in service in 2020, 50 percent of such amount for vehicles placed in service in 2021, and 25 percent of such amount for vehicles placed in service in 2022.

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

### **Current Law**

A tax credit is allowed for fuel-cell vehicles purchased before 2015. The credit is \$20,000 for vehicles weighing more than 14,000 pounds but not more than 26,000 pounds and \$40,000 for vehicles weighing more than 26,000 pounds. There is no tax incentive for other types of alternative-fuel vehicles (vehicles operating on compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, or any liquid at least 85 percent of the volume of which consists of methanol) weighing more than 14,000 pounds.

### **Reasons for Change**

Alternative-fuel vehicles have the potential to reduce petroleum consumption. A tax credit would encourage the purchase of such vehicles and the development of a commercially viable manufacturing base for alternative-fuel medium and heavy-duty vehicles. Making the credit transferable would add flexibility to the market. This flexibility would enable the seller or person financing the sale of these vehicles to offer a point-of-sale rebate to purchasers.

### **Proposal**

The proposal would allow a tax credit of \$25,000 for dedicated alternative-fuel vehicles weighing between 14,000 pounds and 26,000 pounds and \$40,000 for dedicated alternative-fuel vehicles weighing more than 26,000 pounds.

The credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle or to the vehicle's end-use purchaser. If the credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after December 31, 2015, and before January 1, 2022. For vehicles placed in service in calendar year 2021, the credit would be limited to 50 percent of the otherwise allowable amount.

## **MODIFY AND EXTEND THE TAX CREDIT FOR THE CONSTRUCTION OF ENERGY-EFFICIENT NEW HOMES**

### **Current Law**

The general business tax credit included a new energy-efficient home credit available to eligible contractors for the construction of qualified new energy-efficient homes acquired for use as residences. To have qualified as a new energy-efficient home, the home must have been certified in accordance with guidance prescribed by the Secretary to achieve either a 30-percent or 50-percent reduction in heating and cooling energy consumption compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2006 International Energy Conservation Code (IECC) as in effect (including supplements) on January 1, 2006, and any applicable Federal minimum efficiency standards for heating and cooling equipment. For homes meeting the 30-percent standard, one-third of such 30-percent savings must come from the building envelope (i.e., windows, wall, and doors), and for homes meeting the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope. The credit equaled \$1,000 in the case of a new manufactured home (e.g., a mobile home or other pre-built home) that met the 30-percent standard and \$2,000 in the case of a new home that met the 50-percent standard.

In lieu of meeting the 30-percent efficiency improvement relative to the standards of chapter 4 of the 2006 IECC, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the ENERGY STAR Labeled Homes program are eligible for the \$1,000 credit.

The credit applies to homes acquired prior to January 1, 2015.

### **Reasons for Change**

The prior tax credit expired at the end of 2013. The expired credit applied only to energy savings from heating and cooling, which accounts for about half of home energy use. Ideally, the tax incentive would encourage overall energy efficiency, not just heating and cooling efficiency.

In addition, energy efficiency and other home building standards have continued to improve since the prior provision was enacted. For example, ENERGY STAR certified new homes are at least 15 percent more energy efficient than a home built to a model building code which sets minimum energy efficiency standards (the 2009 International Energy Conservation Code), and features additional measures that deliver a total energy efficiency improvement of up to 30 percent compared to a typical new home. These savings may be even higher in States with less rigorous energy efficiency codes. ENERGY STAR certification includes energy efficiency in heating, cooling, and building envelope, in addition to efficiency standards for lighting and appliances and hot water. It also includes a checklist to help ensure quality installation procedures are followed and critical construction details are not omitted. The Department of Energy (DOE) Zero Energy Ready Home program, which began in 2013, is even more ambitious. DOE Zero Energy Ready Homes must meet all ENERGY STAR home requirements

plus additional higher standards for the best proven practices and technologies for energy efficiency, indoor air quality, durability, and readiness for the transition to renewable energy. The ENERGY STAR and DOE Zero Energy Ready Homes requirements are coordinated and share a common certification process.

Re-targeting the tax credit to the ENERGY STAR and DOE Zero Energy Ready Home standards would promote the adoption of high overall energy efficiency standards in the construction of new homes.

### **Proposal**

The proposal would extend the tax credit for homes acquired prior to January 1, 2015. For homes acquired after December 31, 2015, and before January 1, 2026 the proposal would provide a \$1,000 energy efficient new home tax credit for the construction of a qualified ENERGY STAR certified new home acquired for use as a residence. In addition, a \$4,000 tax credit would be provided for the construction of a qualified DOE Zero Energy Ready Home acquired for use as a residence. To ensure that a new home meets ENERGY STAR or DOE Zero Energy Ready Home guidelines, verification by a qualified third party would be required.

## **REDUCE EXCISE TAXES ON LIQUEFIED NATURAL GAS (LNG) TO BRING INTO PARITY WITH DIESEL**

### **Current Law**

An excise tax of 24.3 cents per gallon is imposed on diesel fuel and liquefied natural gas used as highway motor fuels to fund the Highway Trust Fund. With the exception of liquefied petroleum gas (propane), compressed natural gas, and LNG, highway motor fuels are subject to an additional 0.1 cent per gallon tax to fund the Leaking Underground Storage Tank Trust Fund.

Without congressional action, most of these taxes will expire after September 30, 2016. However, a 4.3 cents per gallon fuels tax is a permanent funding mechanism for the Highway Trust Fund and will not expire.

In contrast to current law, and because these excise taxes are routinely extended, the Administration's tax receipts baseline assumes permanent extension. This reflects longstanding practice and conforms to the Balanced Budget and Emergency Control Act of 1985, as amended.

### **Reasons for Change**

Vehicles fueled with LNG emit significantly lower levels of carbon dioxide, nitrogen oxide, and sulfur dioxide compared to diesel-fueled vehicles. In addition, the use of LNG as a transportation fuel helps reduce petroleum consumption. Reducing the excise tax on LNG so that is at parity with diesel fuel on an energy-content adjusted basis would promote the use of natural gas vehicles.

### **Proposal**

The proposal would lower the 24.3 cents per gallon excise tax on LNG to 14.1 cents per gallon beginning after December 31, 2015.

## **ENHANCE AND MODIFY THE CONSERVATION EASEMENT DEDUCTION**

### **Current Law**

A deduction is generally available for contributions of cash and property to tax-exempt charitable organizations. A donor must generally contribute his or her entire interest in donated property to take a deduction; donations of partial interests, i.e., only some of the owner's property rights, are generally not deductible. However, under a special provision, a donor may deduct the fair market value of a qualified conservation contribution – including a contribution of a restriction granted in perpetuity on the use of real property made to a qualified charitable organization exclusively for conservation purposes (a “conservation easement”), including for the preservation of certain certified historic structures. (To qualify as a certified historic structure, a building must either be located in a registered historic district or be listed in the National Register of Historic Places.) This deduction is generally limited to a certain percentage of a taxpayer's income. For individual taxpayers, the deduction is limited to 30 percent of the individual's contribution base (generally, AGI) in the year of the contribution. If the value of the property contributed exceeds this limitation, the individual may deduct the remaining value over the succeeding five years. For corporate taxpayers, the deduction is limited to 10 percent of their taxable income. If any contribution results in a return benefit to the donor, the deduction amount must be reduced by the value of the benefit received.

The Pension Protection Act of 2006 temporarily raised the percentage-of-income limitations for gifts of conservation easements made after December 31, 2005, allowing individuals to deduct up to 50 percent of their contribution base and allowing individuals who are qualified farmers and ranchers to deduct up to 100 percent of their contribution base. In addition, certain corporate farmers and ranchers could deduct the value of contributions of property used in agriculture or livestock production (and restricted so as to remain available for such production) up to 100 percent of taxable income. Additionally, all of these donors could deduct any remaining value of the donated easement over the succeeding 15 years. Although these provisions were extended four times, they lapsed on December 31, 2014.

The Pension Protection Act also added several special requirements for contributions of easements protecting the exterior of buildings located in registered historic districts. These rules do not apply to buildings listed in the National Register of Historic Places.

### **Reasons for Change**

A deduction is permitted for contributions of conservation easements to encourage land owners to restrict development of their land, thereby preserving fragile ecosystems and wildlife habitats, environmentally important open spaces, helping to build resilience to climate change by protecting natural infrastructure, public recreational areas, and historic buildings. Where conservation easements significantly reduce the value of the underlying land interests, economic incentives are needed to encourage landowners to voluntarily restrict development. The current tax deduction for conservation easement donations has been an important incentive for conservation, but it has been of limited value to some donors. Although these donors may own very valuable property, if they have relatively modest incomes, then the current percentage of



income limitations and five-year carryforward provision limit their ability to deduct the full value of their conservation easement donations. The proposal would expand the ability of conservation easement donors – particularly qualified farmers and ranchers – to deduct the full value of the property contributed, increasing the effectiveness of this conservation incentive.

However, the deduction has also proven susceptible to abuse and difficult to administer, leading to numerous disputes between taxpayers and the IRS, and resulting in increased costs and uncertainty for both donors and the IRS. Donors have considerable latitude to determine whether an easement on their property furthers conservation purposes and over the appraised value of the easement, because the donor chooses both the organization holding the easement and the appraiser. While the majority of donors and easement holders act in good faith, there are no repercussions on those organizations that knowingly accept contributions of easements that are overvalued or do not further conservation purposes. Court cases over the last decade have highlighted donors who have taken large deductions for overvalued easements and for easements that allow donors to retain significant rights or that do not further important conservation purposes. For example, large deductions taken for contributions of easements preserving recreational amenities, including golf courses, surrounded by upscale, private home sites have raised concerns both that the deduction amounts claimed for such easements are excessive, and also that the conservation easement deduction is not promoting only bona fide conservation activities, as opposed to the private interests of donors. In addition, easement valuations often do not appropriately take into account existing limitations on the property or rights retained by donors. Reforms are needed to ensure that conservation tax benefits encourage important conservation activities and do not provide opportunities for abuse. The proposal would make changes to the deduction provision to reduce the likelihood that contributed easements are overvalued, to better ensure that contributed easements further bona fide conservation purposes, and to improve the administrability and transparency of the deduction.

In the case of contributions of easements on golf courses and historic preservation easements, where concerns have been particularly strong, the deduction would be eliminated or reduced. The benefit of an easement on a private golf course, especially one that is part of a luxury housing development, may accrue to a limited number of users such as members of the course club or the owners of the surrounding homes, not the general public, and the construction and operation of the course may even result in environmental degradation. Easements on golf courses are particularly susceptible to overvaluation, as private interests often profit from the contribution of the easement. Because of the difficulty determining both the value of the easement and the value of the return benefits provided to the donor – including indirect benefits, such as the increase in the value of home sites surrounding the golf course – it is difficult and costly for the IRS to challenge inflated golf course easement deductions. Thus, no charitable deduction should be allowed for contributions of easements on golf courses.

Similarly, concerns have been raised that the deduction amounts claimed for historic preservation easements are excessive and may not appropriately take into account existing limitations on the property. The value of the easement may be zero if it does not restrict future development more than the restrictions already imposed on the building, for example, by local zoning or historic preservation authorities. Some taxpayers, however, have taken large deductions for contributions of easements restricting the upward development of historic urban

buildings even though such development was already restricted by local authorities. Because of the difficulty of determining the value of the contributed easement, it is difficult and costly for the IRS to challenge deductions for historic preservation easements. To prevent abuses, no deduction should be allowed for the value associated with forgone upward development above an historic building. In addition, to maintain consistency, the special rules applicable to buildings in registered historic districts should be extended to apply to buildings listed in the National Register.

Finally, to address the concerns described above, promote effective conservation efforts, reduce opportunities for abuse, limit uncertainty and compliance burdens for donors and the IRS, and strengthen the relationship between the conservation value the public receives and the cost to the taxpayer of the donor's contribution, the proposal would create a new conservation credit to pilot as an alternative to the current deduction.

The conservation credit would give qualified conservation organizations, which are expert in the conservation priorities and values in their geographic areas of operation, a central role in the distribution of the tax benefit. Under the proposal, conservation organizations would be given an allotment of tax credits to use to further their conservation purposes, which they in turn would allocate to donors of easements. The organizations would have flexibility in their allocation of the credits to donors, and would naturally seek to maximize the amount of conservation value obtained with their conservation credits. The conservation credit would provide increased incentives for donors to contribute easements on important conservation lands by allowing larger tax benefits to be claimed with fewer restrictions. In addition, many of the requirements necessary to ensure compliance in the deduction context would no longer be necessary, reducing the burden on donors of costly compliance, uncertainty and litigation. Furthermore, because conservation organizations would be involved in valuing the easements and have an incentive to ensure that the tax benefits are commensurate with the conservation values received, the conservation credit would result in a more effective tax benefit that obtains better conservation outcomes for the same cost to taxpayers. This approach also would improve tax administration by removing oversight of conservation value from the IRS. Although the IRS would administer the credits, credits would be allocated to qualified organizations by an interagency group, and the value of easements would be determined between the donor and the qualified conservation organizations, who have deep knowledge of the conservation priorities and values in the communities in which they operate.

### **Proposal**

The Administration proposes to make the following enhancements and modifications to the conservation easement deduction.

#### **Permanently enhance incentives and reform the deduction for donations of conservation easements**

This proposal would make permanent the temporary enhanced incentives for conservation easement contributions that expired on December 31, 2014. In addition, to address concerns

regarding abusive uses of this deduction and to promote effective, high-value conservation efforts, the proposal includes a number of reforms:

First, the proposal would strengthen standards for organizations to qualify to receive deductible contributions of conservation easements by requiring such organizations to meet minimum requirements, specified in regulations, which would be based on the experiences and best practices developed in several States and by voluntary accreditation programs. For example, the regulations could, among other things, specify that a “qualified organization” must not be related to the donor or to any person that is or has been related to the donor for at least ten years; must have sufficient assets and expertise to be reasonably able to enforce the terms of all easements it holds; and must have an approved policy for selecting, reviewing, and approving conservation easements that fulfill a conservation purpose. An organization that accepts contributions that it knows (or should know) are substantially overvalued or do not further an appropriate conservation purpose would jeopardize their status as a “qualified organization.”

Second, the proposal would modify the definition of eligible “conservation purposes” for which deductible contributions may be made, requiring that all contributed easements further a clearly delineated Federal conservation policy (or an authorized State or tribal government policy) and yield significant public benefit.

Third, in order to take a deduction, a donor must provide a detailed description of the conservation purpose or purposes furthered by the contribution, including a description of the significant public benefits it will yield, and the donee organization must attest that the conservation purpose, public benefits, and fair market value of the easement reported to the IRS are accurate. Penalties would apply on organizations and organization managers that attest to values that they know (or should know) are substantially overstated or that receive contributions that do not serve an eligible conservation purpose.

Finally, the proposal would require additional reporting of information about contributed conservation easements and their fair market values. Section 6033 would be amended to require electronic reporting and public disclosure by donee organizations regarding deductible contributions of easements that is sufficient for transparency and accountability including: detailed descriptions of the subject property and the restrictions imposed on the property, the conservation purposes served by the easement, and any rights retained by the donor or related persons; the fair market value of both the easement and the full fee interest in the property at the time of the contribution; and a description of any easement modifications or actions taken to enforce the easement that were taken during the taxable year. As is the case under current law, personally identifying information regarding the donor would not be subject to public disclosure.

#### Pilot an allocable credit for conservation contributions and report to Congress

The Administration proposes to pilot a non-refundable credit for conservation easement contributions as an alternative to the conservation contribution deduction (i.e., donors taking the deduction would not be eligible for this credit). The credits of \$100 million per year would be allocated by a Federal interagency board to qualified charitable organizations and governmental entities that hold and enforce conservation easements. These conservation organizations would

in turn allocate the credits to donors of conservation easements. Donors would receive up to a maximum of 50 percent of the fair market value of the contributed easement in credits and could use the credits to offset up to 100 percent of their income tax liability. Any unused credit amounts could be carried forward for up to 15 years. The proposal also calls for a report to Congress from the Secretary of the Treasury in collaboration with the Secretaries of Agriculture and the Interior on the relative merits of the conservation credit and the deduction for conservation contributions, including an assessment of the conservation benefits and costs of both tax benefits.

#### Eliminate the deduction for contributions of conservation easements on golf courses

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

#### Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation

The proposal would disallow a deduction for any value of an historic preservation easement associated with forgone upward development above an historic building. It would also require contributions of conservation easements for all historic buildings, including those listed in the National Register, to comply with a 2006 amendment that requires contributions of historic preservation easements on buildings in registered historic districts to comply with special rules relating to the preservation of the entire exterior of the building and the documentation of the easement contribution.

The proposals are effective for contributions made after the date of enactment.

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

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

#### **Current Law**

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

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

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

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

## **Reasons for Change**

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

## **Proposal**

The proposal would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45 percent and the exclusion amount would be \$3.5 million for estate and GST taxes, and \$1 million for gift taxes. There would be no indexing for inflation. The proposal would confirm that, in computing gift and estate tax liabilities, no estate or gift tax would be incurred by reason of decreases in the applicable exclusion amount with respect to a prior gift that was excluded from tax at the time of the transfer. Finally, the unused estate and gift tax exclusion of a decedent electing portability and dying on or after the effective date of the proposal would be available to the decedent's surviving spouse in full on the surviving spouse's death, but would be limited during the surviving spouse's life to the amount of remaining exemption the decedent could have applied to his or her gifts made in the year of his or her death.

The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2015.

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

### **Current Law**

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

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

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

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

### **Reasons for Change**

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

### **Proposal**

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

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

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

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

The proposal would be effective for transfers after the year of enactment.



## **MODIFY TRANSFER TAX RULES FOR GRANTOR RETAINED ANNUITY TRUSTS (GRATS) AND OTHER GRANTOR TRUSTS**

### **Current Law**

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

Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries. The value of the grantor’s retained annuity is based in part on the applicable Federal rate under section 7520 in effect for the month in which the GRAT is created. Therefore, to the extent the GRAT’s assets appreciate at a rate that exceeds that statutory interest rate, that appreciation will have been transferred, free of gift tax, to the remainder beneficiary or beneficiaries of the GRAT.

If the grantor dies during the GRAT term, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor’s gross estate for estate tax purposes. To this extent, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

Another popular method of removing an asset’s future appreciation from one’s gross estate for estate tax purposes, while avoiding transfer and income taxes, is the sale of the asset to a grantor trust of which the seller is the deemed owner for income tax purposes. A grantor trust is a trust, whether revocable or irrevocable, of which an individual is treated as the owner for income tax purposes. Thus, for income tax purposes, a grantor trust is taxed as if the deemed owner had owned the trust assets directly, and the deemed owner and the trust are treated as the same person. This results in transactions between the trust and the deemed owner being ignored for income tax purposes; specifically, no capital gain is recognized when an appreciated asset is sold by the deemed owner to the trust. For transfer tax purposes, however, the trust and the deemed owner are separate persons and, under certain circumstances, the trust is not included in the deemed owner’s gross estate for estate tax purposes at the death of the deemed owner. In this way, the post-sale appreciation has been removed from the deemed owner’s estate for estate tax purposes.

### **Reasons for Change**

GRATs and sales to grantor trusts are used for transferring wealth while minimizing the gift and income tax cost of transfers. In both cases, the greater the post-transaction appreciation, the

greater the transfer tax benefit achieved. The gift tax cost of a GRAT often is essentially eliminated by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), and by retaining an annuity interest significant enough to reduce the gift tax value of the remainder interest to close to zero. In addition, with both GRATs and sales to grantor trusts, future capital gains taxes can be avoided by the grantor's purchase at fair market value of the appreciated asset from the trust and the subsequent inclusion of that asset in the grantor's gross estate at death. Under current law, the basis in that asset is then adjusted (in this case, "stepped up") to its fair market value at the time of the grantor's death, often at an estate tax cost that has been significantly reduced or entirely eliminated by the grantor's lifetime exclusion from estate tax.

### **Proposal**

The proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years to impose some downside risk in the use of a GRAT. The proposal also would include a requirement that the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or \$500,000 (but not more than the value of the assets contributed). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term, and would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust.

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

The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Code, including without limitation the following: grantor retained income trusts; grantor retained annuity trusts; personal residence trusts; and qualified personal residence trusts. Similarly, it would not apply to any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor. It also would not apply to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor's spouse.

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

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

### **Current Law**

GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor. The GST tax was enacted to prevent the avoidance of estate and gift taxes through the use of a trust that gives successive life interests to multiple generations of beneficiaries. In such a trust, no estate tax would be incurred as beneficiaries died, because their respective life interests would die with them and thus would cause no inclusion of the trust assets in the deceased beneficiary's gross estate. The GST tax is a flat tax on the value of a transfer at the highest estate tax bracket applicable in that year. Each person has a lifetime GST tax exemption (\$5.43 million in 2015) that can be allocated to transfers made, whether directly or in trust, by that person to a grandchild or other "skip person." The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of the transfer or trust assets equal to the amount of GST exemption allocated, but also all appreciation and income on that amount during the existence of the trust.

### **Reasons for Change**

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

Many States now either have repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. (A trust may be situated anywhere; a grantor is not limited to the jurisdiction of the grantor's domicile for this purpose.) As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with \$1 million (the exemption at the time of enactment of the GST tax) and a maximum duration limited by the RAP, to trusts funded with \$5.43 million and continuing (and growing) in perpetuity.

### **Proposal**

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

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

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

## **EXTEND THE LIEN ON ESTATE TAX DEFERRALS WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS**

### **Current Law**

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

### **Reasons for Change**

In many cases, the IRS has had difficulty collecting the deferred estate tax, often because of business failures during that tax deferral period. The IRS sometimes requires either an additional lien or some form of security, but these security interests generally are prohibitively expensive and damaging to the day-to-day conduct and financing of the business. In addition, unless these other security measures are put in place toward the beginning of the deferral period, there is a risk that other creditors could have a higher priority interest than the Government.

### **Proposal**

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

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

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

### **Current Law**

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

### **Reasons for Change**

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

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

### **Proposal**

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

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

## **SIMPLIFY GIFT TAX EXCLUSION FOR ANNUAL GIFTS**

### **Current Law**

The first \$14,000 of gifts made to each donee in 2015 is excluded from the donor's taxable gifts (and therefore does not use up any of the donor's applicable exclusion amount for gift and estate tax purposes). This annual gift tax exclusion is indexed for inflation and there is no limit on the number of donees to whom such excluded gifts may be made by a donor in any one year. To qualify for this exclusion, each gift must be of a present interest rather than a future interest in the donated property. For these purposes, a present interest is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (including life estates and term interests). Generally, a contribution to a trust for the donee is a future interest.

### **Reasons for Change**

To take advantage of this annual gift tax exclusion without having to transfer the property outright to the donee, a donor often contributes property to a trust and gives each trust beneficiary (donee) a *Crummey* power. *Crummey* powers are used particularly in irrevocable trusts to hold property for the benefit of minor children.

In order for a *Crummey* power to convert a donor's transfer into the gift of a present interest, the trustee of the recipient trust must timely notify each beneficiary of the existence and scope of his or her right to withdraw funds from the trust. If the appropriate records cannot be produced at the time of any gift or estate tax audit of the grantor, the gift tax exclusion may be denied to the grantor, thereby causing retroactive changes in the grantor's tax liabilities and remaining applicable exclusion amount. Because of the common use of these withdrawal powers, the number of beneficiaries typically involved, and the differing terms of each such withdrawal power, the cost to taxpayers of complying with the *Crummey* rules is significant, as is the cost to IRS of enforcing the rules.

In addition, the IRS is concerned about the lack of a limit on the number of beneficiaries to whom *Crummey* powers are given. The IRS's concern has been that *Crummey* powers could be given to multiple discretionary beneficiaries, most of whom would never receive a distribution from the trust, and thereby inappropriately exclude from gift tax a large total amount of contributions to the trust. (For example, a power could be given to each beneficiary of a discretionary trust for the grantor's descendants and friendly accommodation parties in the hope that the accommodation parties will not exercise their *Crummey* powers.) The IRS has sought (unsuccessfully) to limit the number of available *Crummey* powers by requiring each powerholder to have some meaningful vested economic interest in the trust over which the power extends. See *Estate of Cristofani v. Comm'r*, 97 T.C. 74 (1991); *Kohlsaat v. Comm'r*, 73 TCM 2732 (1997).

### **Proposal**

The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without



regard to the existence of any withdrawal or put rights), and would impose an annual limit of \$50,000 (indexed for inflation after 2016) per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. This new \$50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of \$50,000 would be taxable, even if the total gifts to each individual donee did not exceed \$14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The proposal would be effective for gifts made after the year of enactment.

## **EXPAND APPLICABILITY OF DEFINITION OF EXECUTOR**

### **Current Law**

The Code defines “executor” for purposes of the estate tax to be the person who is appointed, qualified, and acting within the United States as executor or administrator of the decedent’s estate or, if none, then “any person in actual or constructive possession of any property of the decedent.” This could include, for example, the trustee of the decedent’s revocable trust, an IRA or life insurance beneficiary, or a surviving joint tenant of jointly owned property.

### **Reasons for Change**

Because the tax code’s definition of executor currently applies only for purposes of the estate tax, no one (including the decedent’s surviving spouse who filed a joint income tax return) has the authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent’s death. Thus, there is no one with authority to extend the statute of limitations, claim a refund, agree to a compromise or assessment, or pursue judicial relief in connection with the decedent’s share of a tax liability. This problem has started to arise with more frequency as reporting obligations, particularly with regard to an interest in a foreign asset or account, have increased, and survivors have attempted to resolve a decedent’s failure to comply.

In addition, in the absence of an appointed executor, multiple persons may meet the definition of “executor” and, on occasion, more than one of them has each filed a separate estate tax return for the decedent’s estate or made conflicting tax elections.

### **Proposal**

To empower an authorized party to act on behalf of the decedent in all matters relating to the decedent’s tax liabilities (whether arising before, upon, or after death), the proposal would expressly make the tax code’s definition of executor applicable for all tax purposes, and authorize such executor to do anything on behalf of the decedent in connection with the decedent’s pre-death tax liabilities or obligations that the decedent could have done if still living. In addition, the proposal would grant regulatory authority to adopt rules to resolve conflicts among multiple executors authorized by this provision.

The proposal would apply upon enactment, regardless of a decedent’s date of death.

## **OTHER REVENUE RAISERS**

### **INCREASE AND MODIFY OIL SPILL LIABILITY TRUST FUND FINANCING**

#### **Current Law**

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

The Customs drawback statute (19 U.S.C. 1313) has been administratively interpreted to allow drawback of the tax when products subject to this tax are exported.

#### **Reasons for Change**

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

The drawback of the tax is granted when the product is exported even though there is no concomitant reduction in the risk of an oil spill. A prohibition on the drawbacks of the tax will strengthen the finances of the Oil Spill Liability Trust Fund and remove an incentive to export crude and like products.

#### **Proposal**

The proposal would increase the rate of the Oil Spill Liability Trust Fund tax to nine cents per barrel for periods after December 31, 2015, and to 10 cents per barrel for periods after December 31, 2016. In addition, the proposal would extend the tax to crudes such as those produced from bituminous deposits as well as kerogen-rich rock. The Superfund tax, which would be reinstated under a proposal discussed elsewhere in this volume, would also be imposed on these substances.

The tax would be imposed at the applicable rate on such crudes received at a U.S. refinery, entered into the United States, or used or exported as described above after December 31, 2015.

The proposal would also place a prohibition on the drawback of the tax. This prohibition would be effective for periods after December 31, 2015.

## **REINSTATE SUPERFUND TAXES**

### **Current Law**

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

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

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

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

### **Reasons for Change**

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

### **Proposal**

#### **Reinstate and extend Superfund excise taxes**

The proposal would reinstate the three Superfund excise taxes for periods beginning after December 31, 2015 and before January 1, 2026. In addition, the proposal would extend the excise tax on domestic crude oil and imported petroleum products to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock.

Reinstate Superfund environmental income tax

The proposal would reinstate the corporate environmental income tax for taxable years beginning after December 31, 2015 and before January 1, 2026.

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

### **Current Law**

Tobacco products are taxed at rates set in 2009 as part of the Children's Health Insurance Program Reauthorization Act. Currently, there are numerous tax bases for these products, with some items taxed per-unit, some as a percent of the sales price, and others on a per-pound basis, with different implied tax rates across categories. Cigarettes and small cigars are taxed at \$50.33 per 1,000 (or just over \$1.00 per pack of cigarettes), while large cigars are taxed at 52.75 percent of the sales price (with a maximum of \$402.60 per 1,000). Chewing tobacco is taxed at \$0.5033 per pound, snuff at \$1.51 per pound, pipe tobacco at \$2.8311 per pound, and roll-your-own tobacco at \$24.78 per pound. These tax rates are not indexed for inflation.

### **Reasons for Change**

Despite strong evidence of the negative health effects of tobacco use, more than 14 billion packs of cigarettes were sold in the U.S. in 2013. The Centers for Disease Control estimates that there are roughly 480,000 tobacco related deaths annually and 16 million individuals suffer from tobacco-related illnesses each year. Excise taxes, levied on manufacturers and importers of tobacco products, are one of the main ways that policymakers can affect tobacco production and consumption. Studies have shown that these taxes can decrease harmful consumption and improve health substantially. The existing rate structure imposes wide disparity across similar types of products that may erode the tax base and detract from the beneficial effects of the cigarette tax on consumption and health. In addition, the existing tax rates are not indexed for inflation and therefore erode in real terms over the budget window. Finally, this proposal will reduce the burden of administering tobacco taxes.

### **Proposal**

The proposal would establish a more uniform tax base by taxing most types of tobacco on a similar implied per-pound basis. Cigarettes and small cigars would be taxed at \$97.50 per 1,000 units. Large cigars would be taxed at an approximately equivalent rate (using five per-unit rates that vary according to the cigar's weight). Pipe tobacco and roll-your-own tobacco would be taxed at \$44.23 per pound, which is approximately equal to the implied per-pound tax rate applied to both cigarettes and small cigars. Snuff and chewing tobacco would both be taxed at \$10.00 per pound. The proposal includes a one-time floor stocks tax that generally would apply to tobacco products that are held for sale on January 1, 2016. Floor stocks tax would be payable on or before April 1, 2016. The Administration also proposes to clarify that roll-your-own tobacco would include any processed tobacco that is removed or transferred for delivery to anyone without a proper permit, but does not include export shipments of processed tobacco. The new tax rates would be indexed for inflation beginning in 2017.

The proposal would be effective for articles removed after December 31, 2015.

## **MAKE UNEMPLOYMENT INSURANCE SURTAX PERMANENT**

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would be effective for wages paid on or after January 1, 2016.



## **EXPAND FEDERAL UNEMPLOYMENT TAX ACT (FUTA) BASE**

### **Current Law**

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

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

### **Reasons for Change**

The last increase in the FUTA wage base occurred in 1983 when it was raised from \$6,000 to \$7,000. In aggregate, States entered the last recession with extremely low levels of reserves in their trust funds. Partly because of this, States have accrued large amounts of debt to the Federal UI trust fund. Employers in indebted States face immediate tax increases to repay these debts. These tax increases may discourage job creation at a time when growth is needed. At the same time, many States do not have a long-term plan to restore solvency to their trust funds.

### **Proposal**

The proposal would raise the FUTA wage base in 2017 to \$40,000 per worker paid annually, index the wage base to wage growth for subsequent years, and reduce the net Federal UI tax from 0.8 percent (after the proposed permanent reenactment and extension of the FUTA surtax) to 0.165 percent. States with wage bases below \$40,000 would need to conform to the new FUTA base. The proposal would also impose a minimum tax rate requirement on States for their State employer tax rates equivalent to roughly \$70 per employee beginning in 2017.

The proposal would be effective upon the date of enactment.

## **REDUCE THE TAX GAP AND MAKE REFORMS**

### **Expand Information Reporting**

#### **IMPROVE INFORMATION REPORTING FOR CERTAIN BUSINESSES AND CONTRACTORS**

##### **Current Law**

Generally, payments of dividends, interest, and gross proceeds with respect to an investment in securities are required to be reporting to the IRS and the holder of the investment on a Form 1099-DIV, Form 1099-INT, or a Form 1099-B. Recipients of dividends, interest, and gross proceeds are generally required to provide payors with a certified TIN using a Form W-9, Request for Taxpayer Identification Number and Certification.

In the course of a trade or business, service recipients (“businesses”) making payments aggregating to \$600 or more in a calendar year to any non-employee service provider (“contractor”) that is not a corporation are required to send an information return to the IRS setting forth the amount, as well as name, address, and TIN of the contractor. The information returns, required annually after the end of the year, are made on Form 1099-MISC based on identifying information furnished by the contractor but not verified by the IRS. Copies are provided both to the contractor and to the IRS. Withholding is not required or permitted for payments to contractors. Since contractors are not subject to withholding, they may be required to make quarterly payments of estimated income taxes and self-employment (SECA) taxes near the end of each calendar quarter. The contractor is required to pay any balance due when the annual income tax return is subsequently filed.

Earnings from direct investment in securities generally result in taxable income to the holder. In contrast, investments in comparable assets through a separate account of a life insurance company generally give rise to tax-free or tax-deferred income and payments with respect to these investments are not generally subject to information reporting. This favorable tax treatment for investing through a life insurance company is not available if the policyholder has so much control over the investments in the separate account that the policyholder, rather than the insurance company, is treated as the owner of those investments.

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

Information reporting increases compliance by providing taxpayers with the information that they need to accurately complete their tax returns and by providing the IRS with information that can be used to verify taxpayer compliance. Recipients of dividends, interest, and gross proceeds are required to provide certified TINs to ensure that the taxpayer identifying information filed by payors and received by the IRS is accurate. Without accurate taxpayer identifying information, information reporting requirements impose avoidable burdens on businesses and the IRS, and cannot reach their potential to improve compliance.

Estimated tax filing is relatively burdensome, especially for less sophisticated and lower-income taxpayers. Moreover, by the time estimated tax payments (or final tax payments) are due, some contractors will not have put aside the necessary funds. Given that the SECA tax rate is 15.3 percent (up to certain income limits), the required estimated tax payments can be more than 25 percent of a contractor's gross receipts, even for a contractor with modest income.

An optional withholding method for contractors would reduce the burdens of having to make quarterly payments, would help contractors automatically set aside funds for tax payments, and would help increase compliance.

In some cases, private separate accounts of life insurance companies are being used to avoid tax that would be due if the assets were held directly. Information reporting with respect to investments in private separate accounts will help the IRS to ensure that income is properly reported. Moreover, information reporting will enable the IRS to identify more easily which variable insurance contracts qualify as insurance contracts under current law and which contracts should be disregarded under the investor control doctrine.

## **Proposal**

### **Require a certified TIN from contractors and allow certain withholding**

The proposal would require a contractor receiving payments of \$600 or more in a calendar year from a particular business to furnish to the business (on Form W-9) the contractor's certified TIN. A business would be required to verify the contractor's TIN with the IRS, which would be authorized to disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records. If a contractor failed to furnish an accurate certified TIN, the business would be required to withhold a specified flat-rate percentage of gross payments. Contractors receiving payments of \$600 or more in a calendar year from a particular business could elect to require the business to withhold a flat-rate percentage of their gross payments, with the flat-rate percentage of 15, 25, 30, or 35 percent being selected by the contractor.

### **Require information reporting for private separate accounts of life insurance companies**

In addition, the proposal would require life insurance companies to report to the IRS, for each contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year and represents at least 10 percent of the value of the account, the policyholder's TIN, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that was invested in one or more private separate accounts. For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10 percent of the value of the separate account. Whether a related group of persons owns policies whose cash values represent at least 10 percent of the value of the account would be determined quarterly, based on information reasonably within the issuer's possession.

The proposal would be effective for payments made to contractors after December 31, 2015 or private separate accounts maintained on or after December 31, 2015.

## **PROVIDE AN EXCEPTION TO THE LIMITATION ON DISCLOSING TAX RETURN INFORMATION TO EXPAND TIN MATCHING BEYOND FORMS WHERE PAYMENTS ARE SUBJECT TO BACKUP WITHHOLDING**

### **Current Law**

Section 6103 provides that tax returns and tax return information are confidential and cannot be disclosed, unless a statutory exception applies. Section 6103(k) includes exceptions for disclosure of certain tax returns and tax return information for tax administration purposes. Safeguards apply to certain tax return information and there are civil and criminal penalties for unauthorized inspection or disclosure of tax return information.

Information reporting allows the IRS to verify the accuracy of information reported on the return the payee files and identify and stop tax refund fraud, including fraud resulting from identity theft. Filers are required to obtain and report the TIN of payees and others and include this information on the information returns filed with the IRS and statements furnished to the recipient. In some cases, the TIN must be certified (i.e., the payee must provide the payor with a properly completed Form W-9, Request for Taxpayer Identification and Certification, signed under penalties of perjury). Unless reasonable cause applies, filers are subject to penalties for filing information returns with incorrect or missing TINs.

Under section 3406, reportable payments are subject to backup withholding if the payee fails to furnish a correct TIN to the payor in the manner required or if the payor receives notification from the IRS that backup withholding is required. Section 3406(f) provides that information received under section 3406, including notifications from the IRS, is confidential and may not be used by any person except as set forth in section 3406 and section 6103. The purposes of section 3406 are to ensure that payors receive correct TINs from all payees and that payors include those TINs on information returns filed with the IRS.

Under the broad regulatory authority in section 3406(i) to prescribe regulations necessary or appropriate to carry out the purposes of section 3406, the IRS implemented a voluntary TIN matching program for payors of payments subject to backup withholding. Under the TIN matching program, before filing information returns reporting payments subject to backup withholding, payors confirm with the IRS that the name and TIN combination for payees matches a name and TIN combination in IRS records. Providing the payor with confirmation of a name/TIN combination match with respect to reportable payments subject to backup withholding is a permitted disclosure of taxpayer information under the authority of section 3406.

### **Reasons for Change**

Payors of reportable payments benefit from participating in the TIN matching program because they often are able to resolve mismatches with payees before filing information returns, thereby reducing penalties for filing information returns with incorrect TINs and eliminating the need to correspond with the IRS to establish reasonable cause. The IRS benefits from the TIN matching program because the IRS receives more accurate information resulting in more efficient use of

information returns to verify returns and combat fraud, which in turn conserves scarce resources by reducing correspondence with payors seeking penalty relief.

Because the authority to disclose taxpayer information under the TIN matching program is limited to reportable payments subject to backup withholding under section 3406, taxpayers required to report information other than reportable payments subject to backup withholding are not eligible to participate in the TIN matching program. However, filers and the IRS would benefit if TIN matching were made more widely available.

### **Proposal**

The proposal would amend section 6103(k) to permit the IRS to disclose to any person required to provide the TIN of another person to the Secretary whether the information matches the records maintained by the Secretary.

The proposal would be effective on the date of enactment.

## **PROVIDE FOR RECIPROCAL REPORTING OF INFORMATION IN CONNECTION WITH THE IMPLEMENTATION OF THE FOREIGN ACCOUNT TAX COMPLIANCE ACT**

### **Current Law**

Under current law, U.S. source interest paid to a nonresident alien individual on deposits maintained at U.S. offices of certain financial institutions must be reported to the IRS if the aggregate amount of interest paid during the calendar year is 10 dollars or more. Withholding agents, including financial institutions, also are required to report other payments such as U.S. source dividends, royalties, and annuities paid to any foreign recipient.

The Foreign Account Tax Compliance Act (FATCA) provisions of the Hiring Incentives to Restore Employment Act of 2010 generally require foreign financial institutions, in order to avoid the imposition of a new U.S. withholding tax, to report to the IRS comprehensive information about U.S. accounts, which generally includes financial accounts held by U.S. persons or by certain passive entities with substantial U.S. owners. For example, FATCA requires foreign financial institutions to report account balances, as well as amounts such as dividends, interest, and gross proceeds paid or credited to a U.S. account without regard to the source of such payments. With respect to accounts held by certain passive foreign entities, FATCA requires the reporting of information about any substantial U.S. owners of the entity. Under FATCA and the Treasury regulations issued thereunder, foreign financial institutions generally include foreign depository institutions, custodial institutions, investment entities, and insurance companies that issue cash value insurance. Financial accounts are generally defined as accounts maintained by a financial institution, including, in the case of investment entities, certain debt or equity interests in the investment entity that are not publicly traded.

Foreign financial institutions that report to the IRS information on U.S. accounts are not required to provide a copy of this information to the account holders.

### **Reasons for Change**

The United States has established a broad network of information exchange relationships with other jurisdictions based on established international standards. The information obtained through those information exchange relationships has been central to recent successful IRS enforcement efforts against offshore tax evasion. The strength of those information exchange relationships depends, however, on cooperation and reciprocity. A jurisdiction's willingness to share information with the United States often depends on the United States' willingness and ability to reciprocate by exchanging comparable information.

The ability to exchange information reciprocally is particularly important in connection with the implementation of FATCA. In many cases, foreign law would prevent foreign financial institutions from complying with the FATCA reporting provisions. Such legal impediments can be addressed through intergovernmental agreements under which the foreign government (instead of the financial institutions) agrees to provide the information required by FATCA to the IRS. Requiring financial institutions in the United States to report to the IRS the comprehensive

information required under FATCA with respect to accounts held by certain foreign persons, or by certain passive entities with substantial foreign owners, would facilitate the intergovernmental cooperation contemplated by the intergovernmental agreements by enabling the IRS to provide equivalent levels of information to cooperative foreign governments in appropriate circumstances to support their efforts to address tax evasion by their residents.

In addition, requiring financial institutions that must report information to the IRS under FATCA to also provide a copy of such information to the account holder would promote transparency and increase voluntary tax compliance.

### **Proposal**

The proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. Finally, the Secretary would be granted authority to issue regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal.

The proposal also would require financial institutions that are required under FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders. Electronic copies would be permissible for this purpose. This proposal would not extend to financial institutions in jurisdictions that have an intergovernmental agreement with the United States where the jurisdiction reports FATCA information directly to the IRS.

The proposal would be effective for returns required to be filed after December 31, 2016.



## **IMPROVE MORTGAGE INTEREST DEDUCTION REPORTING**

### **Current Law**

Generally, individuals are not allowed a deduction for personal interest paid or accrued. However, a deduction is allowed for qualified residence interest paid or accrued with respect to a primary residence and one secondary residence. Mortgage interest must meet a number of requirements to be treated as qualified residence interest. For instance, the amount of acquisition indebtedness for which interest may be deductible is limited to \$1 million (\$500,000 in the case of a married individual filing a separate return). In the case of home equity indebtedness (other than acquisition indebtedness), these limitations are \$100,000 and \$50,000, respectively. In addition, special rules apply depending on the date of the mortgage and whether the mortgage is the result of a refinancing. A deduction is also allowed for property taxes paid.

Any person, such as a lender or loan servicer, who in the course of their trade or business, receives from any individual interest aggregating \$600 or more for any calendar year on any mortgage is required to report to the IRS on a Form 1098, Mortgage Interest Statement, with respect to each individual from whom interest is received. The Form 1098 must include, among other things, the name, address, and TIN of the person from whom the interest was received, the amount of interest, the amount of points on the mortgage received during the calendar year and whether the points were paid directly by the borrower, and certain reimbursements. The IRS uses the information it receives on the Form 1098 to verify the deduction of qualified residence interest claimed by the individual on their tax return.

### **Reasons for Change**

The information contained in Form 1098 does not provide the IRS with all of the information that is needed to verify all of the requirements for claiming the deduction for qualified residence interest, or any information about property taxes paid. Requiring filers to report this information on the Form 1098 will improve the IRS's ability to determine whether a taxpayer's claim for a deduction of qualified residence interest or property tax is correct. Reporting this information also has the potential to improve voluntary taxpayer compliance.

### **Proposal**

Under the proposal, in addition to the information already reported on the Form 1098, filers would also be required to include information regarding the outstanding principal balance of the mortgage as of the beginning of the calendar year; the address of the property securing the mortgage; information on whether the mortgage is a refinancing of an existing mortgage during the calendar year; property taxes, if any, paid from escrow; and the loan origination date.

The proposal would be effective for information returns due for calendar years beginning after December 31, 2015.

## **REQUIRE FORM W-2 REPORTING FOR EMPLOYER CONTRIBUTIONS TO DEFINED CONTRIBUTION PLANS**

### **Current Law**

The Code places an annual limit on the amount of employer and employee contributions that can be made for a participant in a tax qualified defined contribution plan. This amount is adjusted annually for cost-of-living increases. The limit is currently \$53,000 for 2015.

Employers are required to provide to each employee an annual statement showing the remuneration paid by the employer to the employee during the calendar year. This statement must be provided on or before January 31 of the following year (or if the employee terminates employment during the year, within 30 days after the receipt of a written request from the employee submitted before January 2). Form W-2, Wage and Tax Statement, is the form used to provide this information. A copy of the Form W-2 must also be filed with the Social Security Administration, which shares information on the form with the IRS.

Employers are required to report on Form W-2 an employee's elective deferrals under a cash or deferred arrangement, such as contributions to a 401(k) plan.

### **Reasons for Change**

Providing information on employer contributions to defined contribution retirement plans, in addition to the current information on employee contributions, would provide workers with a better understanding of their overall retirement savings and compensation. This information would also facilitate compliance with the annual limits on additions to defined contribution plans.

### **Proposal**

This proposal would require employers to report the amounts contributed to an employee's accounts under a defined contribution plan on the employee's Form W-2.

The proposal would be effective for information returns due for calendar years beginning after December 31, 2015.

## **Improve Compliance by Businesses**

### **INCREASE CERTAINTY WITH RESPECT TO WORKER CLASSIFICATION**

#### **Current Law**

For both tax and nontax purposes, workers must be classified into one of two mutually exclusive categories: employees or self-employed (sometimes referred to as independent contractors).

Worker classification generally is based on a common-law test for determining whether an employment relationship exists. The main determinant is whether the service recipient (employer) has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result. For classification purposes, it does not matter whether the service recipient exercises that control, only that he or she has the right to exercise it. Even though it is generally recognized that more highly skilled workers may not require much guidance or direction from the service recipient, the underlying concept of the right to control is the same for them. In determining worker status, the IRS looks to three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test: behavioral control, financial control, and the relationship of the parties.

For employees, employers generally are required to withhold income and Federal Insurance Contribution Act (FICA) taxes and to pay the employer's share of FICA taxes. Employers generally are also required to pay Federal Unemployment Tax Act taxes and State unemployment compensation taxes. Liability for Federal employment taxes and the obligation to report the wages generally lie with the employer.

For workers who are classified as independent contractors, service recipients engaged in a trade or business and making payments totaling \$600 or more in a calendar year to an independent contractor that is not a corporation are required to send an information return to the IRS and to the independent contractor stating the total payments made during the year. The service recipient generally does not need to withhold taxes from the payments reported unless the independent contractor has not provided its TIN to the service recipient. Independent contractors pay Self-Employment Contributions Act (SECA) tax on their net earnings from self-employment (which generally is equivalent to both the employer and employee shares of FICA tax). Independent contractors generally are required to pay their income tax, including SECA liabilities, by making quarterly estimated tax payments.

For workers, whether employee or independent contractor status is more beneficial depends on many factors including the extent to which an independent contractor is able to negotiate for gross payments that include the value of nonwage costs that the service provider would have to incur in the case of an employee. In some circumstances, independent contractor status is more beneficial; in other circumstances, employee status is more advantageous.

Under a special provision (section 530 of the Revenue Act of 1978 which was not made part of the Code), a service recipient may treat a worker as an independent contractor for Federal employment tax purposes even though the worker actually may be an employee under the

common law rules (or a relevant statutory provision) if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. The special provision applies only if (1) the service recipient has not treated the worker (or any worker in a substantially similar position) as an employee for any period beginning after 1977, and (2) the service recipient has filed all Federal tax returns, including all required information returns, on a basis consistent with treating the worker as an independent contractor.

If a service recipient meets the requirements for the special provision with respect to a class of workers, the IRS is prohibited from reclassifying the workers as employees, even prospectively and even as to newly hired workers in the same class. Since 1996, the IRS has considered the availability of the special provision as the first part of any examination concerning worker classification. If the IRS determines that the special provision applies to a class of workers, it does not determine whether the workers are in fact employees or independent contractors. Thus, the worker classification may continue indefinitely even if it is incorrect.

The special provision also prohibits the IRS from issuing generally applicable guidance addressing the proper classification of workers. Current law and procedures also provide for reduced employment tax liabilities for misclassified workers where the special provision is not available but where, among other things, the misclassification was not due to intentional disregard.

### **Reasons for Change**

Since 1978, the IRS has not been permitted to issue general guidance addressing worker classification, and in many instances has been precluded from reclassifying workers – even prospectively – who may have been misclassified. Since 1978, there have been many changes in working relationships between service providers and service recipients. As a result, there has been continued and growing uncertainty about the correct classification of some workers.

Many benefits and worker protections are available only for workers who are classified as employees. Incorrect classification as an independent contractor for tax purposes may spill over to other areas and, for example, lead to a worker not receiving benefits for unemployment (unemployment insurance) or on-the-job injuries (workers' compensation), or not being protected by various on-the-job health and safety requirements.

The incorrect classification of workers also creates opportunities for competitive advantages over service recipients who properly classify their workers. Such misclassification may lower the service recipient's total cost of labor by avoiding payment of employment taxes, and could also provide increased opportunities for noncompliance by service providers.

Workers, service recipients, and tax administrators would benefit from reducing uncertainty about worker classification, eliminating potential competitive advantages and incentives to misclassify workers associated with worker misclassification by competitors, and reducing opportunities for noncompliance by workers classified as self-employed, while maintaining the benefits and worker protections associated with an administrative and social policy system that is based on employee status.

## **Proposal**

The proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law. The reduced employment tax liabilities for misclassification provided under current law would be retained, except that lower penalties would apply only if the service recipient voluntarily reclassifies its workers before being contacted by the IRS or another enforcement agency and if the service recipient had timely filed all required information returns (Forms 1099) reporting the payments to the misclassified workers. For service recipients with only a small number of employees and a small number of misclassified workers, even reduced penalties would be waived if the service recipient (1) had consistently filed timely Forms 1099 reporting all payments to all misclassified workers and (2) agreed to prospective reclassification of misclassified workers. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases the proper classification of workers may not have been clear. (Statutory employee or nonemployee treatment as specified under current law would be retained.)

The Department of the Treasury and the IRS also would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards. This would enable service recipients to properly classify workers with much less concern about future IRS examinations. Treasury and the IRS would be directed to issue guidance interpreting common law in a neutral manner recognizing that many workers are, in fact, not employees. Further, Treasury and the IRS would develop guidance that would provide safe harbors and/or rebuttable presumptions, both narrowly defined. To make that guidance clearer and more useful for service recipients, it would generally be industry- or job-specific. Priority for the development of guidance would be given to industries and jobs in which application of the common law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been failures to report compensation paid.

Service recipients would be required to give notice to independent contractors, when they first begin performing services for the service recipient, that explains how they will be classified and the consequences thereof, e.g., tax implications, workers' compensation implications, wage and hour implications.

The IRS would be permitted to disclose to the Department of Labor information about service recipients whose workers are reclassified.

To ease compliance burdens for independent contractors, independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold for Federal tax purposes a flat rate percentage of their gross payments, with the flat rate percentage being selected by the contractor.

The proposal would be effective upon enactment, but prospective reclassification of those covered by the current special provision would not be effective until the first calendar year beginning at least one year after date of enactment. The transition period could be up to two years for workers with existing written contracts establishing their status.

## **INCREASE INFORMATION SHARING TO ADMINISTER EXCISE TAXES**

### **Current Law**

The Code permits the IRS and the Alcohol Tobacco Tax and Trade Bureau (TTB) to disclose tax return information to Treasury employees whose official duties involve tax administration (section 6103(h)(1)). Prior to 2003, customs officials who had responsibilities for enforcing and/or collecting excise taxes on imports were employees of the Department of the Treasury. Thus, prior to 2003, the Code allowed disclosure of tax return information to these customs officials in the performance of their duties. In 2003, these customs officials were transferred to the Department of Homeland Security (DHS).

### **Reasons for Change**

The transfer of customs officials to DHS, without a corresponding amendment to the Code, resulted in limitations on the information that the IRS and TTB might share with customs officials and hinders effective administration and enforcement of tax laws. (Both IRS and TTB cooperate with Customs and Border Protection in matters involving collection and enforcement of excise taxes.) As a result, DHS, the IRS, and TTB are limited in cooperating on administering excise taxes and tax noncompliance may go undetected and uncorrected.

Allowing the limited disclosure of tax return information to customs officials would facilitate tax administration and improve compliance.

### **Proposal**

The proposal would add employees of DHS (customs officials) involved in tax administration to the list of Federal officers and employees to whom the IRS and TTB may disclose tax returns and return information. The proposal would be effective on the date of enactment.

## **PROVIDE AUTHORITY TO READILY SHARE INFORMATION ABOUT BENEFICIAL OWNERSHIP INFORMATION OF U.S. COMPANIES WITH LAW ENFORCEMENT**

### **Current Law**

#### **Anti-money laundering and counter-terrorism financing provisions**

Illicit actors may abuse legal entities to commit financial crimes, including laundering criminal proceeds and financing terrorism through the international banking system. Knowledge of the beneficial owners of an entity can help law enforcement officials identify and investigate criminals engaged in these activities. In the United States, entities are organized under state rather than Federal law, and the states do not collect information regarding the beneficial ownership of the entities they form.

For anti-money laundering and counter-terrorism financing (AML/CFT) purposes, regulations under Title 31 define beneficial owner of a private banking account to mean an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual(s), directly or indirectly, to control, manage, or direct the account. Generally, an entity must have an employer identification number (EIN) to open an account with a U.S. financial institution.

#### **Tax provisions**

If a person is required by the Code to make a return, statement, or other document, the Secretary has broad regulatory authority to require use of identifying numbers on these documents. The Secretary has broad authority to determine what information is necessary to assign identifying numbers and require that applicants provide this information.

Generally, individuals use their social security numbers (SSN) as an identifying number. Entities requiring an identifying number must apply to the IRS for an EIN to use for this purpose. An entity that is not required by the Code to make a return, statement, or other document and that is not opening an account with a U.S. financial institution is not required to obtain an EIN.

An entity applying for an EIN must provide the IRS with the name of a responsible party who will be the IRS contact for the entity. Generally, for an entity that is not publicly traded, the responsible party is the person who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual to directly or indirectly control, manage, or direct the entity and the disposition of its funds or assets. Entities must update the IRS when there is a change in the responsible party. There is no penalty for failure to update this information.

Tax returns and tax return information are confidential and may not be disclosed without a specific exception under the Code. Under section 6103(i), tax returns and tax return information may be disclosed to law enforcement for use in criminal investigation, provided law enforcement obtains a court order for such disclosure.

## **Reasons for Change**

The definition of responsible party of an entity for Federal tax purposes is similar to the AML/CTF definition of the beneficial owner of a private banking account at a financial institution. Therefore, the responsible party of an entity for Federal tax purposes will generally be considered a beneficial owner of a private banking account nominally owned by the entity for AML/CTF purposes. Knowledge of beneficial owners assists law enforcement officials in identifying and investigating criminals who form and misuse U.S. entities, including entities formed in U.S. territories, to launder criminal proceeds and finance terrorism through the international banking system. However, this information cannot be shared with law enforcement officials in non-tax matters without a court order. In addition, because not all entities formed in the United States and U.S. territories are required to obtain an EIN and provide responsible party information, criminals can hide their identity as beneficial owners of a criminal enterprise formed as an entity in the United States.

## **Proposal**

The proposal would require that all entities formed in a U.S. state or a U.S. territory (U.S. entity) obtain an EIN, which would provide a universal identifier for these entities and ensure that responsible party information is provided for every U.S. entity. The proposal should have no effect on most legitimate business entities because those entities are generally already required to obtain an EIN to file tax returns and engage in normal business activities, such as opening bank accounts.

The proposal also would allow the Secretary or his delegate to share responsible party information with law enforcement without a court order to combat money laundering, terrorist financing, and other financial crimes. Such sharing would advance criminal investigations and successful prosecution, and assist in identifying criminal proceeds and assets.

In addition, the proposal would impose a \$10,000 penalty for failure to obtain an identifying number unless the entity had reasonable cause for the failure. The proposal would also impose a \$100 penalty for failure to update information provided to the Secretary when applying for an identifying number. This penalty could also be waived for reasonable cause. The penalty would increase to \$1,000 for intentional failures (such as a pattern of failing to update information). The penalty for failure to update information would not be imposed for the same calendar year in which the penalty for failure to obtain an identifying number is imposed. If the entity failed to pay either of these penalties within 60 days of notice and demand for payment of the penalty, any person who is or was a responsible party for the entity would be jointly and severally liable for the penalty with the entity. The Secretary would have broad authority to prescribe regulations necessary to carry out these provisions. In addition, a willful failure to obtain an EIN for the purposes of hiding the existence of the entity or the identity of its responsible party, or evading or defeating tax, would be a felony.

The proposal would also provide the Secretary with the authority to impose AML/CFT obligations on persons in the business of forming companies. In addition, the proposal would



establish standards that States would be encouraged to adopt to improve their regulation and oversight of the incorporation process.

The proposed requirement that all U.S. entities obtain an EIN would apply to all such entities formed on or after 180 days after the date of enactment. However, the Secretary would have up to three years to implement the requirement that all U.S. entities have an identifying number. The penalties proposed would be effective for failures occurring after the date of enactment. The proposal would be effective to permit disclosures to law enforcement after the date of enactment of this Act.

## **Strengthen Tax Administration**

### **IMPOSE LIABILITY ON SHAREHOLDERS TO COLLECT UNPAID INCOME TAXES OF APPLICABLE CORPORATIONS**

#### **Current Law**

The IRS and Department of the Treasury have identified “Intermediary Transaction Tax Shelters” as listed transactions that require disclosure on a tax return to avoid certain penalties. These transactions typically involve (1) a sale of a controlling interest in the stock of a C corporation to another entity (an intermediary entity) (2) that is undertaken as part of a plan (3) to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation’s stock.

In a typical case, an intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation’s shareholders, and the consideration received by the C corporation from the sale of its assets is effectively used to repay that loan. These transactions are structured so that when a C corporation’s assets are sold, the C corporation is ultimately left with insufficient assets from which to pay the tax owed from the asset sale. In many cases, the intermediary does not pay the corporate income tax liability and is judgment-proof, frustrating the IRS’ ability to collect taxes that are legally owed.

The transaction may yield the selling shareholders a higher sales price for their C corporation stock than could be supported if the corporate income tax liability were to be paid. However, outside of the consolidated return context, former shareholders of a C corporation generally are not liable for any unpaid income taxes, interest, additions to tax, or penalties owed by the C corporation.

#### **Reasons for Change**

Despite such transactions being identified by the IRS as listed transactions since 2001, shareholders, corporate officers, directors, and their advisors have continued to engage in Intermediary Transaction Tax Shelters or substantially similar transactions. Because the unpaid Federal tax evaded through these transactions is reflected in the price paid for the corporation’s stock, either the buyer or the seller could be liable for such unpaid amounts. Although the Federal government generally has adequate tools under current law to collect amounts from the buyer or its lenders, these parties typically do not have assets in the United States against which the IRS can proceed to collect the unpaid taxes. The selling shareholders are typically the only parties with sufficient assets in the United States against which the IRS could proceed for collection; however, it has proven difficult for the IRS to effectively collect the unpaid Federal taxes from these selling shareholders under current law. Even though the IRS has pursued litigation to enforce collection from the selling shareholders of several corporations, these actions have yielded mixed results in factually similar cases. Thus, existing law does not adequately protect the Federal government’s interest in collecting the amounts due from selling shareholders as a result of these transactions.

## **Proposal**

The proposal would add a new section to the Code that would impose on shareholders who sell the stock of an “applicable C corporation” secondary liability (without resort to any State law) for payment of the applicable C corporation’s income taxes, interest, additions to tax, and penalties to the extent of the sales proceeds received by the shareholders. The proposal applies to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50 percent) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the applicable C corporation stock. The secondary liability would arise only after the applicable 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 applicable C corporation did not pay such amounts within 180 days after assessment.

For purposes of the proposal, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold. The proposal would grant the Department of the Treasury authority to prescribe regulations necessary or appropriate to carry out the proposal.

The proposal would not apply with respect to dispositions of a controlling interest (1) in the stock of a C 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 an applicable C corporation as of the later of a disposition of a controlling interest in its stock or a disposition of all of its assets. The proposal would also amend the Code to provide that the amount that the selling shareholder was secondarily liable for under this proposal would constitute a deficiency that was governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment. The proposal would not limit the government’s ability to pursue any cause of action available under current law against any person.

The proposal would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013.

## **INCREASE LEVY AUTHORITY FOR PAYMENTS TO MEDICARE PROVIDERS WITH DELINQUENT TAX DEBT**

### **Current Law**

The Department of the Treasury is authorized to continuously levy up to 30 percent of a payment to a Medicare provider in order to collect delinquent tax debt. Through the Federal Payment Levy Program, Treasury deducts (levies) a portion of a Government payment to an individual or business in order to collect unpaid taxes.

### **Reasons for Change**

Certain Medicare providers fail to comply with their Federal income tax and/or employment tax obligations. Expanding to 100 percent the amount of Federal payments that can be levied for such providers will help recover a greater amount of delinquent taxes and will promote these providers' compliance with their Federal tax obligations.

### **Proposal**

The proposal would allow Treasury to levy up to 100 percent of a payment to a Medicare provider to collect unpaid taxes.

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

## **IMPLEMENT A PROGRAM INTEGRITY STATUTORY CAP ADJUSTMENT FOR TAX ADMINISTRATION**

### **Current Law**

Previous Administrations and Congresses have used a budget mechanism called a program integrity cap adjustment to increase congressional allocations for annual budget appropriations. Under the mechanism, funding above the spending ceiling that is specified in the annual congressional appropriations process is granted for specified “program integrity” purposes. “Program integrity” broadly refers to maintaining the effectiveness of a specific government program. In the past, Congress has appropriated additional funding to the IRS through allocation adjustments for certain enforcement and compliance activities that generate positive net revenue.

### **Reasons for Change**

The IRS currently collects over \$50 billion in enforcement revenue each year through various enforcement and compliance activities, funded partially through a cap adjustment. These resources have been critical to maintaining the IRS enforcement and compliance functions, allowing the IRS to initiate new programs that generate high returns on investment, and encouraging taxpayers to comply with the tax laws. Additional funding for IRS enforcement and compliance programs will yield increases in enforcement revenue through activities with high returns and will help the IRS further expand and improve its effectiveness and efficiency as a tax administrator.

### **Proposal**

The Administration proposes an adjustment to the discretionary spending limits for IRS tax enforcement, compliance, and related activities, including tax administration activities at the Alcohol and Tobacco Tax and Trade Bureau, through an amendment to the Balanced Budget and Emergency Deficit Control Act of 1985, as amended by the Budget Control Act of 2011. The proposed cap adjustment for fiscal year 2016 will fund \$667 million in enforcement and compliance initiatives and investments above current levels of activity. These resources will help the IRS continue to target international tax compliance and restore previously reduced enforcement levels. Beyond 2016, the Administration proposes further increases in new enforcement and compliance initiatives each fiscal year from 2017 through 2020 and to sustain all of the new initiatives and inflationary costs via cap adjustments through fiscal year 2025. The total cost of supporting new initiatives above the funding needed to maintain current levels of enforcement and compliance activity would be \$18.7 billion over the budget window.

## **STREAMLINE AUDIT AND ADJUSTMENT PROCEDURES FOR LARGE PARTNERSHIPS**

### **Current Law**

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established unified audit rules applicable to all but certain small partnerships.

These rules require the tax treatment of all “partnership items” to be determined at the partnership, rather than the partner, level. In addition to partnership income, gain, deductions, and credits, the term partnership item includes other items such as tax preference items, non-deductible expenditures, and partnership liabilities. The rules also require a partner to report all partnership items consistently with the partnership return, unless the partner notifies the IRS of any inconsistency. If a partner provides the IRS with notice of inconsistency, the IRS may audit the partner even if the IRS does not audit the partnership. However, if the partner does not provide the IRS with a notice of inconsistency, the IRS may immediately assess the partner under the math error procedures.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Nevertheless, the IRS must still assess any resulting adjustment against each of the taxpayers who were partners in the year in which the misstatement of tax liability arose. In addition, any partner can request an administrative adjustment or a refund for his or her own separate tax liability and participate in partnership-level administrative proceedings. The TEFRA partnership rules also require the IRS to give notice within certain time limits of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to the Tax Matters Partner (TMP), as well as to all partners whose names and addresses are furnished to the IRS. Meeting these time limits is a challenge if the partnership does not designate a TMP. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Because “[the TEFRA] audit and adjustment procedures for large partnerships are inefficient and more complex than those for other large entities,”<sup>1</sup> the Taxpayer Relief Act of 1997 established streamlined audit and adjustment procedures, as well as a simplified reporting system, for electing large partnerships (ELPs), which are generally defined as partnerships that have 100 or more partners during the preceding taxable year and elect to be treated as an ELP. Under the streamlined ELP audit and adjustment procedures, the IRS generally makes adjustments at the partnership level that flow through to the current year partners who hold their partnership interest during the year in which the adjustment takes effect. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner’s distributive shares).

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<sup>1</sup> House Conference Report No. 105-220.

## **Reasons for Change**

The present TEFRA partnership audit and adjustment procedures for large partnerships remain inefficient and more complex than those applicable to other large entities. Although the ELP regime was enacted to mitigate problems, few large partnerships have elected into the ELP regime. In addition, there has been substantial growth in the number and complexity of large partnerships, magnifying the difficulty of auditing large partnerships under the TEFRA partnership procedures.

## **Proposal**

The proposal would repeal the existing TEFRA and ELP procedures and instead mandate new simplified partnership procedures (SPP) for any partnership that has 100 or more direct partners in the aggregate during the taxable year to which the adjustment relates (i.e., partnerships that file 100 or more Schedules K-1 for the taxable year) or that has at least one partner that is another partnership, estate, trust, S corporation, nominee, or similar person (“pass-through partner”) at any time during the taxable year to which the adjustment relates. A partnership subject to the SPP regime because it has at least one pass-through partner can elect out of the SPP regime if the partnership can demonstrate that the total number of direct and indirect partners is less than 100 in the aggregate during the taxable year to which the adjustment relates, in which case each partner would be subject to separate deficiency proceedings.

Under the SPP regime, the IRS would audit the partnership (the “source partnership”) and make adjustments at the partnership level that flow through to the partners who held their partnership interest during the year to which the adjustment relates. Any additional tax due as a result of the adjustments would be assessed in accordance with the direct partners’ ownership interest in the partnership for the year to which the adjustments relate. Direct partners that are pass-through partners would be responsible for paying the tax on behalf of their owners. The pass-through partners would have 180 days to challenge the assessment based on the tax attributes of their direct and indirect partners for the year to which the adjustments relate.

Unlike under the TEFRA partnership rules, under the SPP regime only the partnership could request a refund and the partners would not have the right to participate in partnership-level administrative proceedings. In addition, the IRS would not need to give notice to partners of the beginning of an administrative proceeding or of a final adjustment. Instead, a notice of partnership adjustments would be sent to the source partnership, and only the partnership, through an authorized person, could participate in partnership proceedings. Only a U.S. individual could be designated by the partnership to act on its behalf and such individual would be readily identifiable on the source partnership’s return. If the partnership failed to designate an eligible authorized person to act on its behalf, the IRS would designate a person to act on behalf of the partnership.

Under the SPP regime, partners would be required to report partnership items consistent with the partnership, unless the partner notified the IRS of the inconsistent treatment. Similar to the rules under TEFRA, if a partner failed to notify the IRS of inconsistent treatment, the IRS could immediately assess the partner under its math error authority. The SPP regime, however, would

require the IRS to audit the partnership in order to assess a partner who has filed a notice of inconsistent filing. This differs from the TEFRA rules which currently allow the IRS to issue a separate notice of deficiency to the partner who has filed a notice of inconsistent treatment.

The proposal would allow the Secretary to promulgate regulations necessary and appropriate to carry out the purposes of the proposal, including rules to (1) designate a person to act on behalf of the partnership, including when the partnership fails to do so, (2) ensure that taxpayers do not transfer partnership interests with a principal purpose of utilizing the SPP regime to alter the taxpayers' aggregate tax liability, (3) address foreign pass-through partners including, where appropriate, treating a foreign pass-through partner that is a partnership as subject to the SPP regime, and (4) provide rules for pass-through partners to challenge an assessment.

The proposal would apply to a partnership's taxable year ending on or after the date that is two years from the date of enactment.



## **REVISE OFFER-IN-COMPROMISE APPLICATION RULES**

### **Current Law**

Current law provides that the IRS may compromise any civil or criminal case arising under the internal revenue laws prior to a reference to the Department of Justice for prosecution or defense. In 2006, a new provision was enacted to require taxpayers to make certain nonrefundable payments with any initial offer-in-compromise of a tax case. The new provision requires taxpayers making a lump-sum offer-in-compromise to include a nonrefundable payment of 20 percent of the lump-sum with the initial offer. In the case of an offer-in-compromise involving periodic payments, the initial offer must be accompanied by a nonrefundable payment of the first installment that would be due if the offer were accepted.

### **Reasons for Change**

Requiring nonrefundable payments with an offer-in-compromise may substantially reduce access to the offer-in-compromise program. The offer-in-compromise program is designed to settle cases in which taxpayers have demonstrated an inability to pay the full amount of a tax liability. The program allows the IRS to collect the portion of a tax liability that the taxpayer has the ability to pay. Reducing access to the offer-in-compromise program makes it more difficult and costly to obtain the collectable portion of existing tax liabilities.

### **Proposal**

The proposal would eliminate the requirements that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer.

The proposal would be effective for offers-in-compromise submitted after the date of enactment.

## **EXPAND IRS ACCESS TO INFORMATION IN THE NATIONAL DIRECTORY OF NEW HIRES FOR TAX ADMINISTRATION PURPOSES**

### **Current Law**

The Office of Child Support Enforcement of the Department of Health and Human Services maintains the National Directory of New Hires (NDNH), which is a database that contains data from Form W-4 for newly-hired employees, quarterly wage data from State workforce and Federal agencies for all employees, and unemployment insurance data from State workforce agencies for all individuals who have applied for or received unemployment benefits. The NDNH was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Under current provisions of the Social Security Act, the IRS may obtain data from the NDNH, but only for the purpose of administering the earned income tax credit (EITC) and verifying employment reported on a tax return.

Generally, the IRS obtains employment and unemployment data less frequently than quarterly, and there are significant internal costs of preparing these data for use. Under various State laws, the IRS may negotiate for access to employment and unemployment data directly from State agencies that maintain these data.

### **Reasons for Change**

Employment data are useful to the IRS in administering a wide range of tax provisions beyond the EITC, including verifying taxpayer claims and identifying levy sources. Currently, the IRS may obtain employment and unemployment data on a state-by-state basis, which is a costly and time-consuming process. NDNH data are timely, uniformly compiled, and electronically accessible. Access to the NDNH would increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing data without reducing the current levels of taxpayer privacy.

### **Proposal**

The proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for non-compliant taxpayers, and identification of levy sources. Data obtained by the IRS from the NDNH would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

The proposal would be effective upon enactment.

## **MAKE REPEATED WILLFUL FAILURE TO FILE A TAX RETURN A FELONY**

### **Current Law**

Current law provides that willful failure to file a tax return is a misdemeanor punishable by a term of imprisonment of not more than one year, a fine of not more than \$25,000 (\$100,000 in the case of a corporation), or both. A taxpayer who fails to file returns for multiple years commits a separate misdemeanor offense for each year.

### **Reasons for Change**

Increased criminal penalties would help to deter multiple willful failures to file tax returns.

### **Proposal**

The proposal would provide that any person who willfully fails to file tax returns in any three years within any five consecutive year period, if the aggregated tax liability for such period is at least \$50,000, would be subject to a new aggravated failure to file criminal penalty. The proposal would classify such failure as a felony and, upon conviction, impose a fine of not more than \$250,000 (\$500,000 in the case of a corporation) or imprisonment for not more than five years, or both.

The proposal would be effective for returns required to be filed after December 31, 2015.

## **FACILITATE TAX COMPLIANCE WITH LOCAL JURISDICTIONS**

### **Current Law**

Although Federal tax returns and return information (FTI) generally are confidential, the IRS and Department of the Treasury may share FTI with States as well as certain local government entities that are treated as States for this purpose. Generally, the purpose of information sharing is to facilitate tax administration. Where sharing of FTI is authorized, reciprocal provisions generally authorize disclosure of information to the IRS by State and local governments. State and local governments that receive FTI must safeguard it according to prescribed protocols that require secure storage, restricted access, reports to IRS, and shredding or other proper disposal. Criminal and civil sanctions apply to unauthorized disclosure or inspection of FTI. Indian Tribal Governments (ITGs) are treated as States by the tax law for several purposes, such as certain charitable contributions, excise tax credits, and local tax deductions, but not for purposes of information sharing.

### **Reasons for Change**

IRS and Treasury compliance activity, especially with respect to alcohol, tobacco, and fuel excise taxes, may necessitate information sharing with ITGs. For example, the IRS may wish to confirm if a fuel supplier's claim to have delivered particular amounts to adjacent jurisdictions is consistent with that reported to the IRS. If not, the IRS in conjunction with the ITG, which would have responsibility for administering taxes imposed by the ITG, can take steps to ensure compliance with both Federal and ITG tax laws. Where the local government is treated as a State for information sharing purposes, IRS, Treasury, and local officials can support each other's efforts. Where the local government is not so treated, there is an impediment to compliance activity.

### **Proposal**

For purposes of information sharing, the proposal would treat as States those ITGs that impose alcohol, tobacco, or fuel excise or income or wage taxes, to the extent necessary for ITG tax administration. An ITG that receives FTI would be required to safeguard it according to prescribed protocols. The criminal and civil sanctions would apply.

The proposal would be effective for disclosures made after enactment.

## **EXTEND STATUTE OF LIMITATIONS FOR ASSESSMENT FOR OVERSTATED BASIS AND STATE ADJUSTMENTS**

### **Current Law**

In general, the IRS must assess additional Federal tax liabilities in the form of tax, interest, penalties, and additions to tax within three years after the date a return is filed. If an assessment is not made within the required time period, the additional Federal tax liabilities generally cannot be assessed or collected at any future time. In addition, taxpayers generally must claim a refund within three years from the time the return was filed or two years from the time the tax was paid, whichever is later, though exceptions may apply.

The Code contains exceptions to the general statute of limitations. For instance, the general three-year assessment period is increased to six years if the taxpayer omits an amount of gross income that is more than 25 percent of the gross income stated on the return. An overstatement of the adjusted basis of property, which results in an understatement of gain reported on a return, is not treated as an omission of gross income for purposes of determining whether there is a more than 25-percent omission of gross income stated on the return.

State and local authorities employ a variety of statutes of limitations for State and local tax assessments. Pursuant to agreement, the IRS and State and local revenue agencies exchange reports of adjustments made through examination so that corresponding adjustments can be made by each taxing authority. In addition, States provide the IRS with reports of potential discrepancies between State returns and Federal returns.

### **Reasons for Change**

The IRS has six years to assess tax in the case of a substantial omission of gross income but only three years to assess in the case of overstated basis resulting in a corresponding gain understatement, even though the need for more time is the same regardless of whether there is an omission of gross income or an understatement of gain. Therefore, the IRS should have additional time to assess tax due to an understatement of gain as a result of an overstated basis of property.

In addition, the general statute of limitations serves as a barrier to the effective use by the IRS of State and local tax adjustment reports when the reports are provided by the State or local revenue agency to the IRS with little time remaining for assessments to be made at the Federal level. Under the current statute of limitations framework, taxpayers may seek to extend the State statute of limitations or postpone agreement to State proposed adjustments until such time as the Federal statute of limitations expires in order to preclude assessment at the Federal level. In addition, it is not always the case that a taxpayer that files an amended State or local return reporting additional liabilities at the State or local level that also affect Federal tax liability will file an amended return at the Federal level.

## **Proposal**

The proposal would create an additional exception to the general three-year statute of limitations for assessment of Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations would be extended to the greater of: (1) one year from the date the taxpayer first files an amended tax return with the IRS reflecting adjustments to the State or local tax return; or (2) two years from the date the IRS first receives information from the State or local revenue agency under an information sharing agreement in place between the IRS and a State or local revenue agency. The statute of limitations would be extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment. The statute of limitations would not be further extended if the taxpayer files additional amended returns for the same tax periods as the initial amended return or if the IRS receives additional information from the State or local revenue agency under an information sharing agreement. The statute of limitations on claims for refund would be extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the State or local examination report would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

The proposal would also amend the rules for determining gross income for purposes of the six-year assessment period to provide that an understatement of gain is treated as an omission from gross income. As a result, an overstatement of basis and other unrecovered amounts that reduce the amount of gain reported on a return will be treated as an omission of gross income for purposes of determining whether the taxpayer omitted gross income in excess of 25 percent of the gross income stated on the return.

The proposal would be effective for returns required to be filed after December 31, 2015.

## **IMPROVE INVESTIGATIVE DISCLOSURE STATUTE**

### **Current Law**

Generally, tax return information is confidential, unless a specific exception in the Code applies. In the case of tax administration, the Code permits Treasury and IRS officers and employees to disclose return information to the extent necessary to obtain information that is not otherwise reasonably available, in the course of an audit or investigation, as prescribed by regulation. Thus, for example, a revenue agent may identify himself or herself as affiliated with the IRS, and may disclose the nature and subject of an investigation, as necessary to elicit information from a witness in connection with that investigation. Criminal and civil sanctions apply to unauthorized disclosures of return information.

### **Reasons for Change**

Regulations effective since 2003 state that the term “necessary” in this context does not mean essential or indispensable, but rather appropriate and helpful in obtaining the information sought. In other contexts, a “necessary” disclosure is one without which performance cannot be accomplished reasonably without the disclosure. Determining if an investigative disclosure is “necessary” is inherently factual, leading to inconsistent opinions by the courts. Eliminating this uncertainty from the statute would facilitate investigations by IRS officers and employees, while setting forth clear guidance for taxpayers, thus enhancing compliance with the tax code.

### **Proposal**

The proposal would clarify the taxpayer privacy law by stating that the law does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

The proposal would be effective for disclosures made after enactment.

## **ALLOW THE IRS TO ABSORB CREDIT AND DEBIT CARD PROCESSING FEES FOR CERTAIN TAX PAYMENTS**

### **Current Law**

Section 6311 permits the IRS to receive payment of taxes by any commercially acceptable means that the Secretary deems appropriate. Taxpayers may make credit or debit card payments by phone through IRS-designated third-party service providers, but these providers charge the taxpayer a convenience fee over and above the taxes due. Taxpayers cannot make a credit or debit card payment by phone directly to IRS collection representatives. Under current law, if the IRS were to accept credit or debit card payments directly from taxpayers, the IRS is prohibited from absorbing credit or debit card processing fees.

### **Reasons for Change**

When taxpayers agree to make additional payments during telephone consultations with IRS agents, it is inefficient for both taxpayers and the IRS to require taxpayers to contact a third party service provider to make credit and debit card payments. Both the requirement for a separate call to a service provider and the additional processing fee for such payments may also discourage payment of outstanding liabilities, resulting in greater collection costs for the IRS, fewer IRS resources available to contact additional taxpayers, and lower tax collections. Allowing the IRS to accept credit and debit card payments directly and allowing the IRS to absorb the credit and debit card processing fees would increase efficiency and the number of collection cases worked. Permitting the IRS to absorb the processing fee would increase payment options available to taxpayers.

### **Proposal**

The proposal would amend section 6311(d) to allow, but not require, the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for delinquent tax payments, without charging a separate processing fee to the taxpayer.

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



## **PROVIDE THE IRS WITH GREATER FLEXIBILITY TO ADDRESS CORRECTABLE ERRORS**

### **Current Law**

The Code imposes certain procedural requirements on the IRS when it determines that a taxpayer has a deficiency; that is, owes more tax (or is due a smaller refund) than is shown on a tax return. If the IRS conducts an audit and determines that there is a deficiency, a statutory notice of deficiency must be issued, and the taxpayer is provided an opportunity to challenge the proposed deficiency in Tax Court before the deficiency is assessed.

Section 6213(b) contains an exception to the general deficiency procedures that provides the IRS authority to correct certain mathematical or clerical errors made on tax returns (such authority is generally referred to as “math error authority”) to reflect the taxpayer’s correct tax liability. “Mathematical or clerical error” (defined in section 6213(g)(2)) currently includes, among other things: (1) errors in addition, subtraction, multiplication, or division shown on any return; (2) an entry on a return of an item that is inconsistent with another entry of the same or another item on the return; (3) an omission of a correct TIN required to be included on a tax return for certain tax credits; and (4) the inclusion of a TIN indicating that the individual’s age disqualifies them from certain credits.

Currently, section 6213(g)(2) must be amended each time Congress wishes to expand the scope of math error authority.

### **Reasons for Change**

Using math error authority allows the IRS to adjust tax returns in cases where the IRS has reliable information that a taxpayer has an error on his or her return. Using math error authority in these circumstances is an efficient use of IRS resources.

Under current practices, the definition of “mathematical and clerical error” is infrequently revised to account for new or amended Code provisions where the use of math error authority would be an effective use of IRS resources. For example, current law permits the IRS to use math error authority in cases where a taxpayer claiming the first-time home buyer credit does not attach a copy of the settlement statement used to complete the purchase to the taxpayer’s income tax return (as required by the statute). However, the IRS may not use math error authority in other cases where a taxpayer is statutorily required to include documentation with a return but fails to do so and, instead, must use general deficiency procedures.

Changing the current practice would increase efficiency by eliminating the need to enact legislation extending math error authority to the IRS on a case by case basis for particular Code amendments and would promote the efficient use of IRS and taxpayer resources. Granting Treasury regulatory authority to permit the IRS to correct errors in certain narrow circumstances provides an appropriate balance between using IRS resources efficiently and effectively and maintaining the procedural protections available to taxpayers.

## **Proposal**

The proposal would remove the existing specific grants of math error authority, and provide that “math error authority” will refer only to computational errors and the incorrect use of any table provided by the IRS. In addition, the proposal would add a new category of “correctable errors.” Under this new category, Treasury would have regulatory authority to permit the IRS to correct errors in cases where (1) the information provided by the taxpayer does not match the information contained in government databases, (2) the taxpayer has exceeded the lifetime limit for claiming a deduction or credit, or (3) the taxpayer has failed to include with his or her return documentation that is required by statute.

The proposal would be effective on the date of enactment. However, the IRS’ current grant of math error authority would continue to apply until Treasury and the IRS issue final regulations addressing correctable errors.

## **ENHANCE ELECTRONIC FILING OF RETURNS**

### **Current Law**

Generally, regulations may require businesses that file at least 250 returns during the calendar year to file electronically. Under current regulations, taxpayers filing 250 or more of any one type of information return are required to file these returns electronically. Before requiring electronic filing, the IRS and Department of the Treasury are required to take into account the ability of taxpayers to comply at a reasonable cost. Taxpayers may request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer. Although electronic filing is required of certain corporations and other taxpayers, others voluntarily electronically file returns.

Corporations that have assets of \$10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, are required to file electronically their Form 1120/1120S income tax returns. Partnerships with more than 100 partners are required to file electronically, regardless of how many returns they file. Tax-exempt organizations are required to file Forms 990, 990-PF, or 990-EZ, but not the Form 990-T, electronically if the organization files at least 250 returns. In addition, tax-exempt political organizations required to file Form 8872 to report certain political contributions and expenditures must file these returns electronically if the organization has, or expects to have, annual contributions or expenditures in excess of \$50,000.

Employers maintaining certain employee benefit plans and administrators of defined benefit and welfare benefit plans, are generally required under both the Code and Title I of the Employee Retirement Income Security Act of 1974 (ERISA) to file Form 5500 to report information regarding the plans to the IRS and the Department of Labor (DOL). The Form 5500 is filed electronically with the DOL, and the DOL then shares this information with the IRS. Information relevant to employee benefit plans for tax purposes, but not for ERISA purposes (such as data on coverage needed to test compliance with nondiscrimination rules), is not currently collected. Collecting this information would require a separate “IRS only” form that would have to be filed on paper. The Form 8955-SS registration statement that plan administrators file with the IRS is not required to be electronically filed.

Generally, returns prepared using tax return preparation software (either prepared by a paid preparer or self-prepared by the taxpayer) may be filed electronically or a paper copy of the return can be printed and mailed to the IRS. A tax return preparer that expects to file more than 10 individual income tax returns (Forms 1040 and 1041) is generally required to file these tax returns electronically.

There are penalties for failure to file information returns electronically when required to do so. However, there are no penalties for failure to file other returns electronically when required to do so.

## **Reasons for Change**

Electronic filing supports the broader goals of improving IRS service to taxpayers, enhancing compliance, and modernizing tax administration. Expanding electronic filing will help provide tax return information in a more uniform electronic form, which will enhance the ability of the IRS to more productively focus its audit activities. This can reduce burdens on businesses where the need for an audit can be avoided. Overall, increased electronic filing of returns may improve satisfaction and confidence in the filing process.

In the case of tax-exempt organization returns, electronic filing also results in more usable data becoming publicly available more quickly than paper-filed returns, which must first be converted to machine readable format. Once publicly available, the Form 990 series return data may be used by donors to make more informed contribution decisions and by researchers, analysts, and entrepreneurs to understand the tax-exempt sector better and to create information tools and services to meet the needs of the sector. The Form 990 series and Form 8872 return data would also be useful to State and local regulators, charity watch-dog groups, charitable beneficiaries, and the press.

Furthermore, requiring electronic filing of returns is unlikely to impose a large burden on business taxpayers. Corporations, partnerships and many tax-exempt organizations generally maintain financial records in electronic form. Today, most taxpayers either hire tax professionals who use tax preparation software that enables electronic filing or self-prepare returns using tax preparation software that enables electronic filing. In many cases, electronic filing is more cost effective for taxpayers.

Even for taxpayers who are permitted to file on paper, requiring the use of scanning technology would allow the IRS to scan paper tax returns and capture all data shown on the return in electronic form. This would reduce transcription errors and the amount of training, recruiting, and staffing that the IRS requires to process paper tax returns.

## **Proposal**

The proposal would require all corporations and partnerships with \$10 million or more in assets to file their tax returns electronically. In addition, regardless of asset size, corporations with more than ten shareholders and partnerships with more than ten partners would be required to file their tax returns electronically. Preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file these returns electronically.

Regulatory authority would be expanded to allow reduction of the 250-return threshold in the case of information returns such as Forms 1042-S, 1099, 1098, 1096, 5498, 8805, 8955-SSA, and 8966. Any new regulations would be required to balance the benefits of electronic filing against any burden that might be imposed on taxpayers, and implementation would take place incrementally to afford adequate time for transition to electronic filing. Taxpayers would be able to request waivers of this requirement if they cannot meet the requirement due to technological constraints, if compliance with the requirement would result in undue financial burden, or as otherwise specified in regulations.

The proposal would require all tax-exempt organizations that must file Form 990 series returns, including the Form 990-T, or Forms 8872 to file them electronically. The proposal would also require the IRS to make the electronically filed Form 990 series returns and Forms 8872 publicly available in a machine readable format in a timely manner, as provided in regulations.

The proposal would provide the IRS the authority to require electronic filing of information that is relevant only to employee benefit plan tax requirements, so that it can be electronically filed with the Form 5500 electronically filed with the DOL.

The proposal would provide the Secretary with regulatory authority to require all taxpayers who prepare their tax returns electronically but print their returns and file them on paper to print their returns with a scannable code that would enable the IRS to convert the paper return into an electronic format.

The proposal would establish an assessable penalty for a failure to comply with any requirement to file returns (other than information returns) in electronic (or other machine-readable) format. The amount of the penalty would be \$25,000 for a corporations and partnerships, or \$5,000 for a tax-exempt organization or an employee benefit or welfare benefit plan. For failure to file in any format, the existing penalties would remain, and the proposed penalty for failing to file electronically would not apply. The penalty would be waived if it is shown that the failure to file electronically is due to reasonable cause.

The proposal would generally be effective for taxable years beginning after the date of enactment. Transition relief would allow up to three additional years to begin electronic filing for smaller organizations and organizations for which electronic filing would be an undue hardship without additional transition time. In addition, the proposal would give the IRS discretion to delay the effective date for Form 990-T filers for up to three taxable years. The penalty would be effective for returns required to be filed after December 31, 2015.

## **IMPROVE THE WHISTLEBLOWER PROGRAM**

### **Current Law**

Section 7623 of the Code allows whistleblowers to file claims for an award where the whistleblower submitted information that allowed the IRS to detect tax underpayments or detect and bring to trial and punishment persons guilty of violating the internal revenue laws.

Other whistleblower statutes, such as the False Claims Act, explicitly provide whistleblowers with protection from retaliatory actions and whistleblowers who suffer retaliatory action may file a claim in U.S. district court for relief, including reinstatement, back pay, and other damages. There are currently no protections from retaliatory action for whistleblowers who file claims under the Code.

Section 6103 provides that tax returns and tax return information are confidential, unless an exception applies. Currently, the IRS Whistleblower Office may share tax return information with whistleblowers and their legal representatives in a whistleblower administrative proceeding under section 6103(h) or where the whistleblower and its representatives enter into a written agreement with the IRS under section 6103(n). Whistleblowers and their representatives who receive tax return information under a section 6103(n) agreement are subject to the section 6103(p) safeguarding requirements, and civil and criminal penalties may apply for unauthorized inspections and disclosures of tax return information. These same protections do not currently extend to information disclosed to whistleblowers in an administrative proceeding under section 6103(h).

### **Reasons for Change**

The lack of protection from retaliation for whistleblowers who file claims under section 7623 of the Code may discourage whistleblowers from filing claims with the IRS, even though the IRS's general policy is to protect whistleblowers' identities. These safeguards do not fully protect the whistleblower's identity because the IRS may need to identify the whistleblower as a trial witness in the underlying tax case. Moreover, some taxpayers have brought lawsuits against the IRS to discover whether there is a whistleblower who has submitted information about their tax issues and, if so, the whistleblower's identity. Explicitly protecting whistleblowers from retaliatory actions should encourage potential whistleblowers to file claims, which would increase the tax administration benefit of the whistleblower program.

Most disclosures of tax return information are subject to the section 6103(p) safeguarding requirements, and civil and criminal penalties may apply for unauthorized inspections and disclosures of tax return information. The few exceptions are generally cases where re-disclosure of the tax return information may be beneficial or necessary; for example, the safeguarding requirements do not apply to disclosures made under section 6103(i)(4), which permits the IRS to disclose tax return information to Federal officers who administer laws that do not relate to tax administration for use in a judicial or administrative proceeding (i.e., using tax returns as evidence in a non-tax case). There is not a similar policy rationale for exempting whistleblower administrative proceedings from the safeguarding requirements. Furthermore,

whistleblowers and their representatives who receive tax return information under section 6103(h) should be subject to the same requirements as whistleblowers and their representatives who receive tax return information under a section 6103(n) agreement because, in both instances, the tax return information is being disclosed to further tax administration and the goals of the whistleblower program.

### **Proposal**

The proposal would amend section 7623 to explicitly protect whistleblowers from retaliatory actions, consistent with the protections currently available to whistleblowers under the False Claims Act. In addition, the proposal would amend section 6103 to provide that the section 6103(p) safeguarding requirements apply to whistleblowers and their legal representatives who receive tax return information in whistleblower administrative proceedings and extend the penalties for unauthorized inspections and disclosures of tax return information to whistleblowers and their legal representatives. The proposal would not affect a potential whistleblower's ability to file a claim for award or participate in a whistleblower administrative proceeding. The proposal would be effective upon enactment.

## **INDEX ALL CIVIL TAX PENALTIES FOR INFLATION**

### **Current Law**

The Code contains numerous penalty provisions that impose a fixed civil tax penalty amount (including floors and caps imposed with respect to penalties) was established when the penalty was initially added to the Code. These provisions generally contain no mechanism to adjust the amount of the penalty for inflation. For returns required to be filed after December 31, 2014, recently enacted legislation indexes annually for inflation (subject to specified rounding rules) certain select fixed-dollar civil tax penalties for: (1) the failure to file a tax return but only with respect to the \$135 amount applicable in the case of a failure to file the return within 60 days of the date prescribed for filing (determined with regard to extensions); (2) the failure by exempt organizations and certain trusts to file certain returns; (3) the failure of a paid preparer to meet certain obligations; (4) the failure of a partnership or an S corporation to timely file a correct return; and (5) the failure to timely file correct information returns and payee statements.

### **Reasons for Change**

One of the key goals of an effective tax penalty regime is to encourage compliance, which can be achieved, in part, by setting penalty amounts at a level that serves as a meaningful economic deterrent to non-compliant behavior. Under current practices, however, many penalties are not adjusted for inflation. Thus, the amount of a penalty often declines for many years in real, inflation adjusted terms, and so becomes too low to continue serving as an effective deterrent. While recent amendments to the Code indexing select penalty provisions to inflation resolve these issues for those few penalties, a more comprehensive approach is needed to achieve increased effectiveness and efficiency of civil tax penalties.

### **Proposal**

The proposal would index all civil tax penalties with a fixed penalty amount (including floors and caps imposed with respect to penalties) to inflation and round the indexed amount to the next hundred dollars.

The proposal would be effective upon enactment.



## **EXTEND IRS AUTHORITY TO REQUIRE TRUNCATED SOCIAL SECURITY NUMBERS (SSN) ON FORM W-2**

### **Current Law**

Employers are required to furnish written statements to their employees containing certain information. Employers satisfy this requirement by filing with the IRS Form W-2, Wage and Tax Statement, indicating the SSN, wages paid, taxes withheld, and other information, and providing a copy of the Form W-2 to each employee. Section 6051(a) specifically requires the inclusion of the employee's SSN on the statement.

Other statements provided to taxpayers – such as Forms 1099 – are subject to the more general rules under section 6109, which require the filer to include the taxpayer's "identifying number" on the form. Section 6109 provides that, except as otherwise specified in regulations, an individual's SSN is an individual's identifying number for purposes of the Code. As a result, for some statements, Treasury and the IRS have regulatory authority to require or permit filers to use a number other than the taxpayer's SSN.

### **Reasons for Change**

The incidence of identity theft is increasing, and Treasury and the IRS have taken a multi-pronged approach to combating identity theft. For example, in 2009, the IRS instituted a pilot program permitting filers of certain information returns to truncate a taxpayer's identifying number, including an SSN, on copies of information returns provided to taxpayers. Under the pilot program, the first five digits of a taxpayer's identifying number are replaced with X's or \*'s. The pilot program was implemented in response to concerns about identity theft, particularly the concern that a taxpayer's identifying number could be stolen from a paper payee statement and used to file false or fraudulent returns. The pilot program was favorably received and, in January 2013, Treasury and the IRS published proposed regulations that would make the pilot program permanent.

Because section 6051 explicitly requires the inclusion of an employee's SSN, Form W-2 could not be included in the pilot program or the proposed regulations. The risk of identity theft from Form W-2 is high because employers are required to file a Form W-2 for each employee who receives wages. Moreover, both the IRS and many State taxing authorities require taxpayers to include a copy of their Form W-2 when filing their annual income tax returns, increasing the risk that a taxpayer's SSN could be stolen. Providing the IRS authority to require or permit truncated SSNs on Forms W-2 would reduce the risk of identity theft and improper payments resulting from false or fraudulent returns.

### **Proposal**

The proposal would revise section 6051 to require employers to include an "identifying number" for each employee, rather than an employee's SSN, on Form W-2. By revising section 6051 to require an identifying number, the general rules under section 6109 would apply and allow

Treasury and the IRS to exercise regulatory authority to require or permit a truncated SSN on Form W-2.

The proposal would be effective upon enactment.

## **COMBAT TAX-RELATED IDENTITY THEFT**

### **Current Law**

The Aggravated Identity Theft Statute permits an increased sentence when the identity of another individual is used to commit certain crimes that are enumerated in the statute. This enumerated list does not include any tax offenses under the Code in Title 26 or tax-related offenses under Title 18, including conspiracy to defraud the government with respect to claims (18 U.S.C. 286), false, fictitious, or fraudulent claims (18 U.S.C. 287), or conspiracy (18 U.S.C. 371). A conviction for aggravated identity theft adds two years to the sentence imposed for the underlying felony. Current law does not impose a civil penalty for tax-related identity theft.

### **Reasons for Change**

Tax-related identity theft where identity thieves use stolen Social Security numbers to file false or fraudulent tax returns to obtain an improper refund has increased exponentially in recent years. The IRS issued an Identity Protection Personal Identification Number (IP PIN) to 1.2 million individuals for the 2014 filing season, an increase from about 770,000 individual IP PINs that the IRS issued in the previous year. The IP PIN is a unique identifying number that is issued annually to victims of identity theft to use when filing their tax returns. Although Treasury and the IRS have implemented a multi-pronged approach to combating identity theft, additional tools are needed. The addition of tax offenses to the list of predicate offenses for aggravated identity theft and the addition of a civil tax penalty for identity theft would increase the enforcement tools available to combat identity thieves and serve as more effective deterrent.

### **Proposal**

The proposal would add the tax-related offenses in Title 18 and the criminal tax offenses in Title 26 to the list of predicate offenses contained in the Aggravated Identity Theft Statute. If this proposal is enacted, criminals who are convicted for tax-related identity theft may be subject to longer sentences than the sentences that apply to those criminals under current law. In addition, the proposal would add a \$5,000 civil penalty to the Code to be imposed in tax identity theft cases on the individual who filed the fraudulent return. Under the proposal, the IRS would be able to immediately assess a separate civil penalty for each incidence of identity theft. There is no maximum penalty amount that may be imposed.

The proposal would be effective upon enactment.

## **ALLOW STATES TO SEND NOTICES OF INTENT TO OFFSET FEDERAL TAX REFUNDS TO COLLECT STATE TAX OBLIGATIONS BY REGULAR FIRST-CLASS MAIL INSTEAD OF CERTIFIED MAIL**

### **Current Law**

Under current law, the Department of the Treasury, Bureau of the Fiscal Service (Fiscal Service), may offset Federal tax refunds to collect delinquent State income tax obligations only after the State sends the delinquent debtor a notice by certified mail with return receipt. With respect to other types of debts that can be collected via Federal tax refund offset, including Federal nontax debt, unpaid child support, and State unemployment insurance compensation debt, the statute is silent as to the notice delivery method. However, the regulations require that, for all debts other than State income tax obligations, Federal and State creditor agencies send notices by regular first class mail. Similarly, notice requirements for other debt collection actions, including administrative wage garnishment, do not require delivery by certified mail.

### **Reasons for Change**

With the recent postal increase, certified mail with return receipt costs \$5.51 more per item than first class mail. Based on information received from 21 States before the postage increase, the estimated costs for States to send notices by certified mail totaled \$14.3 million in 2012.

There is no evidence that certified mail is more likely to reach the debtor than regular first class mail. In fact, it is more likely that the recipient will not receive the notice, because certified mail either provides a recipient who is at home an opportunity to refuse delivery or requires a recipient who is not at home to go to the Post Office to sign for a letter.

The legislative history of the Internal Revenue Service Restructuring and Reform Act of 1998 does not provide a reason for the certified mail with return receipt requirement. Similarly, there appears to be no policy reason why offsets for State income tax debts should have different due process notice requirements from offsets to collect other types of debts, which generally allow the use of first class mail. The ability to use first class mail to send notices for delinquent State tax obligations would save the States considerable expense while providing uniformity of due process requirements for tax refund offsets.

### **Proposal**

The proposal would remove the statutory requirement to use certified mail, thereby allowing the Fiscal Service to amend its regulations to permit States to send notices for delinquent State income tax obligations by first class mail. The proposal would be effective on the date of enactment.

## **RATIONALIZE TAX RETURN FILING DUE DATES SO THEY ARE STAGGERED**

### **Current Law**

Individuals are generally required to file their income tax returns by April 15 of the year following the close of the taxable year. An individual may request a six-month extension of time to file his or her income tax return.

Calendar year corporations (i.e., corporations with a tax year ending on December 31), including S corporations, are required to file their income tax returns by March 15 of the year following the close of the taxable year. Fiscal year corporations (i.e., corporations with a tax year ending on a date other than December 31), including S corporations, are required to file their income tax returns by the 15<sup>th</sup> day of the third month following the close of the taxable year. Corporations may request an automatic six-month extension of time to file their income tax returns. In addition, corporations classified as S corporations are required to provide shareholders with a copy of the Schedule K-1 by the due date (including extensions) of the S corporation's income tax return.

Calendar year partnerships are required to file the Form 1065 with the IRS and furnish a copy of the Schedule K-1 to each partner by April 15 of the year following the close of the taxable year. For fiscal year partnerships, the due date is the 15<sup>th</sup> day of the fourth month following the close of the taxable year. Partnerships may request an automatic five-month extension of time to file the Form 1065 and furnish copies of the Schedule K-1 to partners.

Most information returns, including Forms 1099, 1098, and 1096, are required to be filed with the IRS by February 28 of the year following the year for which the information is being reported. Form W-2 is required to be filed with the Social Security Administration (SSA) by the last day of February. A copy of the information filed with the IRS is generally required to be furnished to payees by January 31 of the year following the year for which the information is being reported. In the case of payments reported on the Form 1099-B, statements to payees are required to be furnished by February 15, rather than January 31. The due date for filing information returns with the IRS or SSA is generally extended until March 31 if the returns are filed electronically.

### **Reasons for Change**

Third-party information is used by taxpayers to assist them in preparing their income tax returns. However, many taxpayers do not receive Schedules K-1 before their income tax returns are due. As a result, taxpayers may not have accurate information when they file their income tax returns. Accelerating the taxpayer's receipt of third-party information will reduce burden on taxpayers by providing them with accurate information when preparing their original returns and potentially reduce the number of amended returns filed by taxpayers.

The IRS also uses third-party information to determine a taxpayer's compliance with Federal tax obligations. Accelerating the IRS's receipt of third-party information will facilitate detection of non-compliance earlier in the filing season.

## **Proposal**

The proposal would rationalize income tax return due dates so that taxpayers receive Schedules K-1 before the due date for filing their income tax returns. Under the proposal, calendar year S corporation filing deadlines would remain the same, and partnership filing deadlines would be made to conform to the current deadlines imposed on S corporations. Accordingly, all calendar year partnership and all calendar year S corporation returns (Forms 1065 and 1120-S) and Schedules K-1 furnished to partners and shareholders would be due March 15. In addition, returns of calendar year corporations other than S corporations would be due April 15 instead of March 15. Fiscal year partnership returns would be due the 15<sup>th</sup> day of the third month following the close of the taxable year and fiscal year corporations other than S corporations would be due the 15<sup>th</sup> day of the fourth month following the close of the taxable year.

The proposal would also accelerate the due date for filing information returns and eliminate the extended due date for electronically filed returns. Under the proposal, information returns would be required to be filed with the IRS (or SSA, in the case of Form W-2) by January 31, except that Form 1099-B would be required to be filed with the IRS by February 15. The due dates for the payee statements would remain the same.

The proposal would be effective for returns required to be filed after December 31, 2015.

## **INCREASE OVERSIGHT AND DUE DILIGENCE OF PAID TAX RETURN PREPARERS**

### **Current Law**

Taxpayers are increasingly turning to paid tax return preparers and software to assist them in meeting their tax filing obligations. Under 31 U.S.C. §330, the Secretary has the authority to regulate practice before the IRS. Regulations under that section, referred to as “Circular 230,” regulate the practice of licensed attorneys, certified public accountants, and enrolled agents and actuaries. In 2009, in response to concerns about the lack of regulation of unlicensed and unenrolled paid tax return preparers, IRS conducted a formal review of its regulation of paid tax return preparers. After significant consideration and input from taxpayers, tax professionals, and other stakeholders, Treasury and the IRS amended Circular 230 to regulate practice of all paid tax return preparers, including individuals who are unlicensed and unenrolled. Paid tax return preparers challenged these regulations in *Loving v. Commissioner*. The Court of Appeals for the District of Columbia Circuit determined that these regulations exceeded the IRS’ authority.

In addition, the Code imposes certain penalties on paid tax return preparers. For instance, the Code imposes a penalty on paid tax return preparers for understatements of tax due to unreasonable positions taken on a return or claim for refund (section 6694(a)). The penalty for understatements of tax due to unreasonable positions is the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the preparer with respect to the return or claim for refund. This penalty will not be imposed if there is reasonable cause for the understatement and the preparer acted in good faith.

There is a separate penalty on paid tax return preparers for understatements of tax that occur as a result of a paid preparer’s willful or reckless conduct (section 6694(b)). The penalty for understatements due to willful or reckless conduct is the greater of \$5,000 or 50 percent of the income derived (or to be derived) by the preparer with respect to the return or claim for refund, and no reasonable cause exception applies.

The Code also imposes a \$500 penalty on paid tax return preparers who fail to meet certain due diligence requirements with respect to the earned income tax credit (EITC). To meet the due diligence requirements, a paid tax return preparer must complete the Paid Preparer’s Earned Income Credit Checklist (Form 8867) and the checklist must be filed with the taxpayer’s return claiming the EITC. Preparers must also meet certain record-keeping requirements. Even though the eligibility requirements for the child tax credit (CTC) and the eligibility requirements for the EITC, including the definition of a qualifying child, are similar, paid preparers are not required to meet similar due diligence requirements for the CTC.

### **Reasons for Change**

Paid tax return preparers have an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. Incompetent and dishonest tax return preparers increase collection costs, reduce revenues, disadvantage taxpayers by potentially subjecting them to penalties and interest as a result of incorrect returns, and undermine

confidence in the tax system. Regulation of paid tax return preparers, in conjunction with diligent enforcement, will help promote high quality services from paid tax return preparers, will improve voluntary compliance, and will foster taxpayer confidence in the fairness of the tax system.

Often preparers are subject to the same penalty amount for understatements of tax on returns they prepare, regardless of whether the preparer's conduct was willful and reckless. This is because in many cases, 50 percent of the income derived (or to be derived) by the preparer is often greater than the fixed dollar penalties that may be imposed. Having the same penalty for willful and non-willful conduct does not sufficiently discourage willful or reckless behavior and is unfair to paid tax return preparers whose conduct was not willful.

Extending the due diligence requirement to the CTC, which shares many eligibility criteria with the EITC, could improve compliance with respect to claims for the CTC without excessively increasing the level of burden on paid preparers or taxpayers. The IRS estimates that the tax gap attributable to individual income tax credits was \$28 billion in 2006 (before enforcement actions). The EITC due diligence requirements are part of the IRS's robust program to educate tax return preparers and to identify noncompliant EITC return preparers, who are audited and penalized.

### **Proposal**

#### Extend paid preparer EITC due diligence requirements to the child tax credit

The proposal would extend due diligence requirements similar to those for the EITC to the CTC. The existing checklist would be expanded and adapted to reflect the differences in requirements between the EITC and the child tax credit, while ensuring that the additional burden to preparers and filers is minimized.

This proposal would be effective for returns required to be filed after December 31, 2015.

#### Explicitly provide that the Department of the Treasury and IRS have authority to regulate all paid return preparers

The proposal would explicitly provide that the Secretary has the authority to regulate all paid tax return preparers.

This proposal would be effective on or after the date of enactment.

#### Increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct

The proposal would increase the penalty rate (in section 6694(b)) on paid tax return preparers for understatements due to willful or reckless conduct to the greater of \$5,000 or 75 percent (instead of the current 50 percent) of the income derived (or to be derived) by the preparer with respect to the return or claim for refund.



This proposal would be effective for returns required to be filed after December 31, 2015.

## **ENHANCE ADMINISTRABILITY OF THE APPRAISER PENALTY**

### **Current Law**

Section 6694 imposes a penalty on paid tax return preparers for understatements of tax due to unreasonable positions taken on a return or claim for refund and for understatements of tax that occur as a result of a paid preparer's willful or reckless conduct. The penalty will not be imposed if there is reasonable cause for the understatement and the preparer acted in good faith.

Section 6695A imposes a penalty on any person who prepares an appraisal of the value of property, if the person knows or reasonably should have known that the appraisal would be used in connection with a return or claim for refund, and if the claimed value of the property based on the appraisal results in a substantial or gross valuation misstatement. There is an exception to the penalty if the value in the appraisal is "more likely than not" the proper value.

### **Reasons for Change**

Taxpayers must determine the value of property to correctly determine the tax consequences of a gift, bequest, sale, exchange, or other transaction involving the property. An appraisal generally states the value of property as a specific dollar amount or as an amount within a certain range of dollar values. Unlike opinions on tax issues, whether a value is "more likely than not" the correct value is not typically addressed in an appraisal. Therefore, "more likely than not" is not an administrable standard for an exception to the appraisal penalty.

Further, there is no coordination between the section 6695A penalty on appraisers and the section 6694 understatement penalty on return preparers in cases where the person providing the appraisal is also treated as a paid tax return preparer with respect to the position on the return or claim for refund relying on the valuation in the appraisal. Therefore, a paid tax return preparer could be subject to penalties under both section 6694 and section 6695A with respect to the same conduct.

### **Proposal**

The proposal would replace the existing "more likely than not" exception to the section 6695A appraiser penalty with a reasonable cause exception. In addition, the proposal would coordinate the section 6694 and section 6695A penalties so that an appraiser would not be subject to the penalty under section 6695A if, by reason of that appraisal, the appraiser is also subject to a penalty under section 6694.

The proposal would be effective for returns required to be filed after December 31, 2015.

## **SIMPLIFY THE TAX SYSTEM**

### **MODIFY ADOPTION CREDIT TO ALLOW TRIBAL DETERMINATION OF SPECIAL NEEDS**

#### **Current Law**

Taxpayers that adopt children can receive a tax credit for qualified adoption expenses. The amount of the credit is increased in the case of adoption of a special needs child. To be eligible for the increased credit, a State must determine that the child meets the statutory requirements as a “child with special needs.” Under the statute, other governmental entities, such as Indian Tribal Governments (ITGs) do not have the authority to make this determination.

Congress passed the Indian Child Welfare Act (ICWA) in 1978 in response to the high number of Indian children being removed from their homes by public agencies. Among other things, the ICWA allows tribes to manage and maintain adoption programs, in the place of the State, for the children of their tribal members.

#### **Reasons for Change**

Like States, many ITGs facilitate adoptions involving special needs. The ICWA programs mirror the programs that are administered by State agencies, and ITGs should be accorded the same deference as State agencies for purposes of the tax credit for adoption expenses.

#### **Proposal**

The proposal would amend the tax credit for adoption expenses to allow ITGs to make the status determination of a “child with special needs.”

The proposal would be effective for taxable years beginning after December 31, 2015.

## **REPEAL NON-QUALIFIED PREFERRED STOCK (NQPS) DESIGNATION**

### **Current Law**

In 1997, Congress added a provision to section 351 that treats NQPS as taxable “boot” for certain purposes. In addition to its treatment as boot in corporate organizations, NQPS is also treated as boot in certain shareholder exchanges pursuant to a plan of corporate reorganization. NQPS is stock that (i) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (ii) has a dividend rate that varies with reference to an index, or, in certain circumstances, a put right, a call right, or a mandatory redemption feature. The addition of this provision reflected the belief that the receipt of certain types of preferred stock more appropriately represented taxable consideration because the investor/transferor obtained a more secure form of investment.

### **Reasons for Change**

NQPS is treated like debt for certain limited purposes but is otherwise generally treated as stock. This hybrid nature of NQPS has transformed it into a staple of affirmative corporate tax planning: its issuance often occurs in loss-recognition planning, where NQPS is treated as debt-like boot, or to avoid the application of a provision that treats a related-party stock sale as a dividend. Thus, for the unwary, the designation and treatment of NQPS represents a proverbial trap that adds additional complexity to the Code, while for the well-advised, the issuance of NQPS often arises in transactions that are inconsistent with the original purpose of the 1997 provision.

### **Proposal**

The proposal would repeal the NQPS provision and other cross-referencing provisions of the Code that treat NQPS as boot.

The proposal would be effective for stock issued after December 31, 2015.

## **REPEAL PREFERENTIAL DIVIDEND RULE FOR PUBLICLY TRADED AND PUBLICLY OFFERED REAL ESTATE INVESTMENT TRUSTS (REITS)**

### **Current Law**

REITs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a “preferential dividend.” For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. Previously, a similar rule had applied to all regulated investment companies (RICs). Section 307 of the Regulated Investment Company Modernization Act of 2010 repealed application of that rule for publicly offered RICs.

### **Reasons for Change**

The original purpose of the preferential dividend rule in 1936 was to prevent tax avoidance by closely held personal holding companies. The inflexibility of the rule can produce harsh results for inadvertent deviations in the timing or amount of distributions to some shareholders. Because an attempt to compensate for a preference in one distribution produces a preference in a second offsetting distribution, it is almost impossible to undo the impact of a prior error. As applied to publicly traded REITs and publicly offered REITs, the rule has ceased to serve a necessary function either in preventing tax avoidance or in ensuring fairness among shareholders. Today, for these shareholders, corporate and securities laws bar preferences and ensure fair treatment.

### **Proposal**

The proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

1. As of the record date of the distribution, the REIT was publicly traded; or
2. As of the record date of the distribution:
  - a. The REIT was required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Act of 1934;
  - b. Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318); and
  - c. Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period.

The Secretary would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

The proposal would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.

## **REFORM EXCISE TAX BASED ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS**

### **Current Law**

Private foundations that are exempt from Federal income tax generally are subject to a two-percent excise tax on their net investment income. The excise tax rate is reduced to one percent in any year in which the foundation's distributions for charitable purposes exceed the average level of the foundation's charitable distributions over the five preceding taxable years (with certain adjustments). Private foundations that are not exempt from Federal income tax, including certain charitable trusts, must pay an excise tax equal to the excess (if any) of the sum of the excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. Under current law, private nonoperating foundations generally are required to make annual distributions for charitable purposes equal to five percent of the fair market value of the foundation's noncharitable use assets (with certain adjustments). The amount that a foundation is required to distribute annually for charitable purposes is reduced by the amount of the excise tax paid by the foundation.

### **Reasons for Change**

The current "two-tier" structure of the excise tax on private foundation net investment income may discourage foundations from significantly increasing their charitable distributions in any particular year. An increase in a private foundation's distributions in one year will increase the foundation's five-year average percentage payout, making it more difficult for the foundation to qualify for the reduced one-percent excise tax rate in subsequent years. Because amounts paid by foundations in excise tax generally reduce the funds available for distribution to charitable beneficiaries, eliminating the "two-tier" structure of this excise tax would ensure that a private foundation's grantees do not suffer adverse consequences if the foundation increases its grant-making in a particular year to respond to charitable needs (for example, disaster relief). Such a change would also simplify both the calculation of the excise tax and charitable distribution planning for private foundations.

### **Proposal**

The proposal would replace the two rates of tax on private foundations that are exempt from Federal income tax with a single tax rate of 1.35 percent. The tax on private foundations not exempt from Federal income tax would be equal to the excess (if any) of the sum of the 1.35-percent excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions would be repealed.

The proposal would be effective for taxable years beginning after the date of enactment.

## **REMOVE BONDING REQUIREMENTS FOR CERTAIN TAXPAYERS SUBJECT TO FEDERAL EXCISE TAXES ON DISTILLED SPIRITS, WINE, AND BEER**

### **Current Law**

The Alcohol and Tobacco Tax and Trade Bureau (TTB) collects taxes on distilled spirits, wines, and beer under the Code.

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), was enacted on August 10, 2005. Section 11127, “Quarterly Excise Tax Filing for Small Alcohol Excise Taxpayers” of SAFETEA-LU amended section 5061(d)(4) of the Code so that importers and producers of distilled spirits, wine, and beer with a reasonably expected excise tax liability of \$50,000 or less in a calendar year, who were liable for not more than \$50,000 in such taxes in the preceding calendar year, could file returns and pay taxes within 14 days after the end of the calendar quarter.

The option for small beverage alcohol excise taxpayers (“small taxpayers”) to file and pay taxes quarterly, rather than semi-monthly, currently only applies to withdrawals, removals, and entries (and articles brought into the United States from Puerto Rico) under bond.

Additionally, TTB has administratively allowed eligible wineries who paid excise taxes in an amount less than \$1,000 during the previous calendar year to file taxes annually pursuant to the regulatory bond framework promulgated under the bond authority for wineries in section 5354 of the Code and the tax return period filing authority under section 5061 of the Code.

### **Reasons for Change**

For calendar year 2013, 88 percent (7,004 of 7,916) of beverage alcohol taxpayers (manufacturers, producers, and importers of distilled spirits, wine, and beer) had a tax liability of less than \$50,000. Of these, 1,981 still filed semi-monthly, although they have the option to file quarterly.

Small taxpayers may choose to continue to file taxes semi-monthly because they would have to increase their deferral bond amounts if they were to file taxes quarterly. By eliminating the bond requirements for small taxpayers, quarterly filing would be less burdensome. This would also lessen the burden for TTB in processing the tax payments.

Distilled spirits and beer taxpayers who paid excise taxes in an amount less than \$1,000 during the previous calendar year are not eligible to file taxes annually, as wineries are.

### **Proposal**

The proposal would require any distilled spirits, wines, and beer taxpayer who reasonably expects to be liable for not more than \$50,000 per year in alcohol excise taxes (and who was liable for not more than \$50,000 in such taxes in the preceding calendar year) to file and pay such taxes quarterly, rather than semi-monthly. The proposal would also create an exemption



from the bond requirement in the Code for these small taxpayers. The proposal includes conforming changes to the other sections of the Code describing bond requirements.

Additionally, the proposal would allow any distilled spirits, wine, or beer taxpayer with a reasonably expected alcohol excise tax liability of not more than \$1,000 per year to file and pay such taxes annually rather than on a quarterly basis. The proposal will create parity among alcohol taxpayers by allowing eligible distilled spirits and beer taxpayers to file annually as well.

The proposal would be effective 90 days after the date of enactment.

## **SIMPLIFY ARBITRAGE INVESTMENT RESTRICTIONS**

### **Current Law**

Section 103 provides generally that interest on debt obligations issued by State and local governments for governmental purposes is excludable from gross income. Section 148 imposes two types of complex arbitrage investment restrictions on investments of tax-exempt bond proceeds pending use for governmental purposes. These restrictions generally limit investment returns that exceed the yield or effective interest rate on the tax-exempt bonds. One type of restriction, called “yield restriction,” limits investment returns in the first instance, and a second type, called “rebate,” requires issuers to repay arbitrage investment earnings to the Federal Government at prescribed intervals. These restrictions developed in different ways over a long period of time, beginning with yield restriction in 1969 and continuing with the extension of the rebate requirement to all tax-exempt bonds in 1986. Various exceptions apply in different ways to these two types of arbitrage restrictions, including exceptions for prompt expenditures of bond proceeds, reasonable debt service reserve funds, small issuers, and other situations.

With respect to spending exceptions, a two-year construction spending exception to arbitrage rebate under section 148(f)(4)(C) applies to certain categories of tax-exempt bonds (including bonds for governmental entities and nonprofit entities, but excluding most private activity bonds). This two-year construction spending exception has semiannual spending targets, bifurcation rules to isolate construction expenditures, and elective penalties in lieu of rebate for failures to meet spending targets. Separately, a longstanding regulatory three-year spending exception to yield restriction is available for all tax-exempt bonds used for capital projects.

A small issuer exception to arbitrage rebate under section 148(f)(4)(D) applies to certain governmental small issuers with general taxing powers if they issue no more than \$5 million in tax-exempt bonds in a particular year. The small issuer exception has been in effect since 1986 without change, except for an increase to \$15 million for certain public school expenditures.

### **Reasons for Change**

The arbitrage investment restrictions create unnecessary complexity and compliance burdens for State and local governments in several respects. In general, the two types of arbitrage restrictions (yield restriction and rebate) are duplicative and overlapping and they have the same tax policy objective to limit arbitrage profit incentives for excess issuance of tax-exempt bonds. While Treasury Regulations have integrated these restrictions partially, further statutory integration of the arbitrage restrictions could provide a simpler and more unified framework.

Moreover, the two-year construction spending exception to arbitrage rebate is extremely complex. This exception has restricted eligibility rules, unduly-short spending targets, and complex penalty elections that are rarely used. A streamlined spending exception could provide meaningful simplification and reduce compliance burdens. Limited arbitrage potential exists if issuers spend proceeds fairly promptly. By comparison, a recent uniform provision for qualified tax credit bonds under section 54A has a simplified three-year spending exception to arbitrage restrictions, along with a requirement to redeem bonds upon a failure to meet the spending rules.

An increase in the small issuer exception to arbitrage rebate would reduce compliance burdens for a large number of State and local governmental issuers while affecting a disproportionately smaller amount of tax-exempt bond dollar volume. For example, in 2013, issuers under a similar \$10 million small issuer exception for bank-qualified tax-exempt bonds under section 265 issued about 46 percent of the total number of tax-exempt bond issues (5,229 out of 11,435 total bond issues), but only 6.0 percent of total dollar volume (\$20.2 billion out of \$334.6 billion).

### **Proposal**

The proposal would unify yield restriction and rebate further by relying on arbitrage rebate as the principal type of arbitrage restriction on tax-exempt bonds. The proposal generally would repeal yield restriction, subject to limited exceptions under which yield restriction would continue to apply to investments of refunding escrows in advance refunding issues under section 149(d) and to other situations identified in regulations.

The proposal would also provide a broader streamlined three-year spending exception to arbitrage rebate for tax-exempt bonds that meet the following requirements:

1. Eligible tax-exempt bonds would include all governmental bonds and private activity bonds, excluding only bonds used for advance refundings under section 149(d) or restricted working capital expenditures (as defined in regulations).
2. The tax-exempt bonds would be required to have a fixed yield and a minimum weighted average maturity of at least five years.
3. The issuer would be required to spend 95 percent of the bond within three years after the issue date. (This five-percent de minimis provision broadens the availability exception to cover many circumstances in which minor amounts of bond proceeds remain unspent for bona fide reasons.)
4. The issuer would be required to satisfy a due diligence standard in spending the bond proceeds.

Upon a failure to meet the spending requirements for this exception, the tax-exempt bond issue would revert to become subject to the arbitrage rebate requirement.

The proposal also would increase the small issuer exception to the arbitrage rebate requirement for tax-exempt bonds from \$5 million to \$10 million and index the size limit for inflation. The proposal also would remove the general taxing power constraint on small issuer eligibility.

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

## **SIMPLIFY SINGLE-FAMILY HOUSING MORTGAGE BOND TARGETING REQUIREMENTS**

### **Current Law**

Section 143 allows use of tax-exempt qualified mortgage bonds to finance mortgage loans for owner-occupied single-family housing residences, subject to a number of targeting requirements, including, among others: a mortgagor income limitation (generally not more than 115 percent of applicable median family income, increased to 140 percent of such income for certain targeted areas, and also increased for certain high-cost areas); a purchase price limitation (generally not more than 90 percent of average area purchase prices, increased to 110 percent in targeted areas); refinancing limitation (generally only new mortgages for first-time homebuyers are eligible); and a targeted area availability requirement. In addition, the general restrictions on tax-exempt private activity bonds apply to these qualified mortgage bonds, including, among other restrictions, the State private activity bond volume cap under section 146.

### **Reasons for Change**

The targeting requirements for qualified mortgage bonds are complex and excessive. The mortgagor income limit generally serves as an appropriate limit to target this lower cost borrowing subsidy to a needy class of low- and moderate-income beneficiaries. The mortgagor income limit typically is a more constraining factor than the purchase price limit. The restriction against refinancing limits the availability of this lower cost borrowing subsidy as a tool to address needs for affordable mortgage loan refinancing within a needy class of existing low- and moderate-income homeowners.

### **Proposal**

The proposal would repeal the purchase price limitation under section 143(e) and the refinancing limitation under section 143(d) on tax-exempt qualified mortgage bonds.

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

## **STREAMLINE PRIVATE BUSINESS LIMITS ON GOVERNMENTAL BONDS**

### **Current Law**

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

Subsidiary restrictions further reduce the permitted thresholds of private involvement for governmental bonds in several ways. Section 141(b)(3) imposes a five-percent unrelated or disproportionate private business use limit. Section 141(b)(4) imposes a \$15 million cap on private business involvement for governmental output facilities (such as electric, gas, or other output generation, transmission, and distribution facilities, but excluding water facilities). Section 141(c) imposes a private loan limit equal to the lesser of five percent or \$5 million of bond proceeds. Section 141(b)(5) requires a volume cap allocation for private business involvement that exceeds \$15 million in larger transactions which otherwise comply with the general 10-percent private business limits.

### **Reasons for Change**

The 10-percent private business limit generally represents a sufficient and workable threshold for governmental bond status. The volume cap requirement for private business involvement in excess of \$15 million serves a control on private business involvement in larger transactions.

The particular subsidiary restriction which imposes a five-percent limit on unrelated or disproportionate private business use introduces undue complexity, a narrow disqualification trigger, and attendant compliance burdens for State and local governments. The five-percent unrelated or disproportionate private business use test requires difficult factual determinations regarding the relationship of private business use to governmental use in financed projects. This test is difficult to apply, particularly in governmental bond issues that finance multiple projects.

### **Proposal**

The proposal would repeal the five-percent unrelated or disproportionate private business use test under section 141(b)(3) to simplify the private business limits on tax-exempt governmental bonds.

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

## **REPEAL TECHNICAL TERMINATIONS OF PARTNERSHIPS**

### **Current Law**

Under section 707(b)(1)(B) of the Code, if within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits, the partnership is treated as having terminated for U.S. Federal income tax purposes.

### **Reasons for Change**

A termination of this kind is commonly referred to as a “technical termination” because the termination occurs solely for U.S. Federal income tax purposes, even though the entity continues to exist for local law purposes and the business of the partnership continues. Even though the business of the partnership continues in the same legal form, several unanticipated consequences occur as a result of a technical termination, including, among other things, the restart of section 168 depreciation lives, the close of the partnership’s taxable year, and the loss of all partnership level elections. Accordingly, this rule currently serves as a trap for the unwary taxpayer or as an affirmative planning tool for the savvy taxpayer.

### **Proposal**

The proposal would repeal section 708(b)(1)(B) effective for transfers after December 31, 2015.

## **REPEAL ANTI-CHURNING RULES OF SECTION 197**

### **Current Law**

In 1993, Congress enacted section 197 of the Code to allow the amortization of certain intangibles (such as goodwill and going concern value). Prior to the enactment of section 197, such intangibles were not amortizable. To “prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under [prior] law into amortizable property,” Congress enacted section 197(f)(9), which excludes an intangible from the definition of amortizable section 197 intangible if (1) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the “transition period”), by the taxpayer or related person; (2) the taxpayer acquired the intangible from a person who held it at any time during the transition period, and, as part of the transaction, the user of the intangible does not change; or (3) the taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

### **Reasons for Change**

The rules under section 197(f)(9) are complex. Because it has been more than 20 years since the enactment of section 197, most of the intangibles that exist today did not exist during the transition period and, thus, would not be subject to section 197(f)(9). Even though the number of intangibles subject to section 197(f)(9) may be minor, taxpayers must nevertheless engage in due diligence to determine whether such intangibles exist and then navigate the complex rules of section 197(f)(9). Accordingly, the complexity and administrative burden associated with section 197(f)(9) outweighs the current need for the provision.

### **Proposal**

The proposal would repeal section 197(f)(9) effective for acquisitions after December 31, 2015.

## **REPEAL SPECIAL ESTIMATED TAX PAYMENT PROVISION FOR CERTAIN INSURANCE COMPANIES**

### **Current Law**

An insurance company uses reserve accounting to compute losses incurred. That is, losses incurred for the taxable year includes losses paid during the taxable year (net of salvage and reinsurance recovered), plus or minus the increase or decrease in discounted unpaid losses during the year. An adjustment is also made for the change in discounted estimated salvage and reinsurance recoverable.

Unpaid losses are determined on a discounted basis to account for the time that may elapse between an insured loss event and the payment or other resolution of the claim. Taxpayers may, however, elect under section 847 to take an additional deduction equal to the difference between the amount of their reserves computed on a discounted basis and the amount computed on an undiscounted basis. In order to do so, a taxpayer must make a special estimated tax payment (SETP) equal to the tax benefit attributable to the additional deduction. In addition, the additional deductions are added to a special loss discount account. In future years, as losses are paid, amounts are subtracted from the special discount account and included in gross income; the SETPs are used to offset tax generated by these income inclusions. To the extent an amount added to the special loss discount account is not subtracted within 15 years, it is automatically subtracted (and included in gross income) for the 15<sup>th</sup> year. This regime of additional deductions and SETPs is, by design, revenue neutral.

### **Reasons for Change**

Although this provision is revenue neutral, it imposes a substantial recordkeeping burden on both taxpayers and the IRS. Records must be maintained for up to 15 years for both amounts added to the special loss discount account and amounts paid as SETPs. Additional complexities frequently arise, such as when a taxpayer has a net operating loss carryback, or when a taxpayer is subject to regular tax in one year and alternative minimum tax in another. Also, further complexity arises under section 847 because an insurance company must account for tax benefits that would arise from the filing of a consolidated return with other insurance companies without taking into account statutory limitations on the absorption of losses of non-life insurers against income of life insurance companies. Section 847 was originally enacted in order to enable insurers to establish deferred tax assets associated with loss reserve discounting. However, liberalized accounting requirements were subsequently promulgated, which made section 847 unnecessary for that purpose.

### **Proposal**

The proposal would repeal section 847, effective for taxable years beginning after December 31, 2015.

The entire balance of any existing special loss discount account would be included in gross income for the first taxable year beginning after December 31, 2015, and the entire amount of existing SETPs would be applied against additional tax that is due as a result of that inclusion.



Any SETPs in excess of the additional tax that is due would be treated as an estimated tax payment under section 6655.

In lieu of immediate inclusion in gross income for the first taxable year beginning after December 31, 2015, taxpayers would be permitted to elect to include the balance of any existing special loss discount account in gross income ratably over a four taxable year period, beginning with the first taxable year beginning after December 31, 2015. During this period, taxpayers would be permitted to use existing SETPs to offset any additional tax that is due as a result of that inclusion. At the end of the fourth year, any remaining SETPs would be treated as an estimated tax payment under section 6655.

## **REPEAL THE TELEPHONE EXCISE TAX**

### **Current Law**

The Code imposes a three-percent excise tax on amounts paid for taxable communications services, which include local telephone service and toll telephone service. Local telephone service is defined as access to a local telephone system and the privilege of telephonic communication with substantially all persons having telephones in the local system. Toll telephone service is defined to include both (1) telephonic quality communication for which there is a toll charge that varies in amount with the distance and elapsed transmission time of each individual call, and (2) telephone service that (a) provides the right to an unlimited number of telephone calls to points in a specified area that is outside the local telephone system and (b) is subject to a periodic charge determined either as a flat amount or upon the basis of total elapsed transmission time.

Until the mid-1990s, most long-distance charges were based on the time and distance of each call. Since then, the industry has shifted to charges based solely on time, which are not subject to the tax. The IRS has announced that taxpayers are also not required to pay tax on similar services, such as plans that provide bundled local and long distance service for either a flat monthly fee or a charge that varies with the elapsed transmission time for which the service is used. As a result, the only communications services that remain subject to the tax are purely local telephone services.

### **Reasons for Change**

It is likely that for most taxpayers, purely local telephone service will continue to be replaced over time by nontaxable services. Those who continue to purchase purely local services subject to the telephone excise tax will increasingly be poor and elderly. Thus the tax increasingly will be inequitable.

### **Proposal**

All taxes on communications services, including the tax on local telephone service, would be repealed.

The proposal would be effective for amounts paid pursuant to bills first rendered more than 90 days after enactment of legislation repealing the tax.

## **INCREASE THE STANDARD MILEAGE RATE FOR AUTOMOBILE USE BY VOLUNTEERS**

### **Current Law**

Under current law, taxpayers may deduct unreimbursed expenses directly related to the use of an automobile in giving services to a charitable organization. As an alternative to tracking actual expenses, taxpayers may use a standard mileage rate of 14 cents per mile. This rate is set by statute and is not indexed for inflation or otherwise adjusted over time.

Similarly, a taxpayer may claim a deduction for expenses incurred when using an automobile for medical reasons or in the course of a move. The standard mileage rate applicable to medical and moving expenses is set annually by the IRS to cover the variable costs of operating an automobile. For tax year 2015, the rate for medical and moving expenses is 23 cents per mile.

### **Reasons for Change**

Standard mileage rates simplify record-keeping and reduce compliance costs by eliminating the need to track actual expenses and offering the alternative of tracking only miles driven. However, since the mileage rate for charitable use of a vehicle was last increased in 1997, price increases have substantially eroded the value of a deduction computed using the standard rate relative to the actual expenses incurred. As a result, a taxpayer incurring typical expenses in operating his or her vehicle would need to give up a substantial fraction of the deduction to which he or she would otherwise be entitled to make use of the standard mileage rate. This reduction in value makes the standard mileage rate less effective in achieving the goals of facilitating compliance and reducing compliance costs.

### **Proposal**

The proposal would set the standard mileage rate for the charitable contribution deduction equal to the rate set by the IRS for purposes of the medical and moving expense deduction. It would likewise be adjusted annually to reflect the estimated variable costs of operating a vehicle.

The proposal would be effective for taxable years beginning after December 31, 2015.

## **CONSOLIDATE CONTRIBUTION LIMITATIONS FOR CHARITABLE DEDUCTIONS AND EXTEND THE CARRYFORWARD PERIOD FOR EXCESS CHARITABLE CONTRIBUTION DEDUCTION AMOUNTS**

### **Current Law**

Current law limits the amount of charitable contribution deductions a donor may claim to a share of the donor's contribution base (the taxpayer's AGI computed without regard to any net operating loss carryback for the taxable year). A taxpayer may generally deduct up to 50 percent of his or her contribution base for contributions of cash to public charities, and up to 30 percent for cash contributions to most private foundations. A taxpayer may generally deduct up to 30 percent of his or her contribution base for contributions of appreciated capital gain property to public charities, and up to 20 percent to most private foundations. Finally, a taxpayer may deduct up to 20 percent of his or her contribution base for contributions of capital gain property for the use of a charitable organization. Charitable contributions to an organization exceeding these limits may be carried forward to be deducted in the subsequent five years. Contributions for the use of an organization exceeding these limits may not be carried forward. These limitations are applied prior to the overall limitation on itemized deductions (the so-called Pease limitation).

### **Reasons for Change**

The contribution base limitations generate significant complexity in the tax system. Consolidation of these limitations would ease the burden on both taxpayers and tax administrators and has the potential to improve compliance.

### **Proposal**

The proposal would simplify this complicated set of rules limiting deductions for charitable contributions. Under the proposal, the contribution base limit would remain at 50 percent for contributions of cash to public charities. For all other contributions, a single deduction limit of 30 percent of the taxpayer's contribution base would apply, irrespective of the type of property donated, the type of organization receiving the donation, and whether the contribution is to or for the use of the organization. In addition, the proposal would extend the carry-forward period for contributions in excess of these limitations from five to 15 years.

The proposal would be effective for taxable years beginning after December 31, 2015.

## **EXCLUDE FROM GROSS INCOME SUBSIDIES FROM PUBLIC UTILITIES FOR PURCHASE OF WATER RUNOFF MANAGEMENT**

### **Current Law**

In response to concerns about water use and the impact of storm water runoff on water quality, many State and local governments, often through local public water utilities, offer subsidies to individuals for the purchase or installation of water conservation and storm water runoff management measures associated with their dwellings. Under current law these subsidies should be included in gross income for Federal tax purposes.

### **Reasons for Change**

Water conservation and storm water management measures taken by individuals can reduce water consumption and improve water quality in lakes and streams. Many State and local governments provide subsidies to individuals to meet these policy goals. Excluding water conservation and storm water management subsidies from gross income would encourage more individuals to take the water consumption and water-quality improvement actions that are supported by these subsidies.

### **Proposal**

The proposal would exclude from gross income of individuals the value of any subsidy provided by a public utility for the purchase or installation of any water conservation measure or storm water management measure. Water conservation measures are any installation, modification, or water-use evaluation primarily designed to reduce consumption of water or to improve the management of water demand with respect to a dwelling unit. Storm water management measures are any installation or modification of property to offset or manage the amounts of storm water runoff associated with a dwelling unit. Public utilities are any entity engaged in the sale of water to customers or in sewage treatment and may include the Federal government or a State or local government.

The proposal would be effective for subsidies provided for water conservation and storm water management after December 31, 2015.

## **PROVIDE RELIEF FOR CERTAIN ACCIDENTAL DUAL CITIZENS**

### **Current Law**

An individual may become a U.S. citizen at birth either by being born in the United States (or in certain U.S. territories or possessions) or by having a parent who is a U.S. citizen. All U.S. citizens generally are subject to U.S. income taxation on their worldwide income, even if they reside abroad. In contrast, nonresident aliens are taxed on certain income derived from U.S. sources and on income that is effectively connected with a U.S. trade or business.

U.S. citizens that reside abroad also may be subject to tax in their country of residence. Potential double taxation is generally relieved in two ways. First, U.S. persons can credit foreign taxes paid against their U.S. taxes due, with certain limitations. Second, U.S. individuals may exclude from their U.S. taxable income a certain amount of income earned from working outside the United States (\$100,800 for 2015).

Section 877A imposes special rules on certain individuals who relinquish their U.S. citizenship or cease to be lawful permanent residents of the United States (“expatriates”). Expatriates who are “covered expatriates” generally are required to pay a mark-to-market exit tax on a deemed disposition of their worldwide assets as of the day before their expatriation date.

An expatriate is a covered expatriate if he or she meets at least one of the following three tests: (1) has an average annual net income tax liability for the five taxable years preceding the year of expatriation that exceeds a specified amount that is adjusted for inflation (the “tax liability test”), (2) has a net worth of \$2 million or more as of the expatriation date (the “net worth test”), or (3) fails to certify, under penalty of perjury, compliance with all U.S. Federal tax obligations for the five taxable years preceding the taxable year that includes the expatriation date (the “certification test”).

The definition of covered expatriate includes a special rule for an expatriate who became at birth a citizen of both the United States and another country at birth and, as of the expatriation date, continues to be a citizen of, and taxed as a resident of, such other country. Such an expatriate will be treated as not meeting the tax liability or net worth tests if he or she has been a resident of the United States for not more than 10 taxable years during the 15-taxable year period ending with the taxable year during which the expatriation occurs. However, such an expatriate remains subject to the certification test. Because U.S. citizens are subject to U.S. Federal income tax on their worldwide income, dual citizens who choose to expatriate may be required to pay a significant amount of U.S. tax before they are able to certify that they have satisfied their U.S. tax obligations for the five taxable years preceding the year in which they expatriate.

### **Reasons for Change**

Individuals who became citizens of both the United States and another country at birth may have had minimal contact with the United States and may not learn until later in life that they are U.S. citizens. In addition, these individuals may be citizens of countries where dual citizenship is illegal. Many of these individuals would like to relinquish their U.S. citizenship in accordance

with established State Department procedures, but doing so would require them to pay significant U.S. tax.

### **Proposal**

Under the proposal, an individual will not be subject to tax as a U.S. citizen and will not be a covered expatriate subject to the mark-to-market exit tax under section 877A if the individual:

1. became at birth a citizen of the United States and a citizen of another country,
2. at all times, up to and including the individual's expatriation date, has been a citizen of a country other than the United States,
3. has not been a resident of the United States (as defined in section 7701(b)) since attaining age 18½,
4. has never held a U.S. passport or has held a U.S. passport for the sole purpose of departing from the United States in compliance with 22 CFR §53.1,
5. relinquishes his or her U.S. citizenship within two years after the later of January 1, 2016, or the date on which the individual learns that he or she is a U.S. citizen, and
6. certifies under penalty of perjury his or her compliance with all U.S. Federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period.

The proposal would be effective January 1, 2016.

## **USER FEE**

### **REFORM INLAND WATERWAYS FUNDING**

#### **Current Law**

The Inland Waterways Trust Fund is authorized to pay 50 percent of the capital costs of the locks and dams and other features that make commercial transportation possible on the inland and intracoastal waterways. This trust fund is supported by an excise tax on liquids used as fuel in a vessel in commercial waterway transportation, which Congress recently increased to 29 cents per gallon. The excise tax applies to commercial waterway transportation on waterways listed in section 206 of the Inland Waterways Revenue Act of 1978, as amended. Commercial waterway transportation is defined as any use of a vessel on a listed waterway: (1) in the business of transporting property for compensation or hire; or (2) in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage). Exceptions are provided for deep-draft ocean-going vessels, passenger vessels, State and local governments, and certain ocean-going barges.

#### **Reasons for Change**

The fuel excise tax does not raise enough revenue to pay the full amount of the authorized expenditures from this trust fund. Moreover, the tax is not the most efficient method for financing expenditures on those waterways. Additional funding to supplement the amount collected from the excise tax can be provided through a more efficient user fee system.

#### **Proposal**

The proposal would reform the laws governing the Inland Waterways Trust Fund, including establishing a new user fee. The proposal would increase the amount paid by commercial navigation users sufficiently to meet their share of the costs of activities financed from this trust fund. The Secretary of the Army would set the amount of the user fee each year to collect a total of \$1.1 billion from the user fee over the first 10 years. Thereafter, the Secretary of the Army would adjust the user fee over time, so that the combined amount collected from the excise tax and the user fee covers the user-financed share of spending for inland waterways construction, replacement, expansion, and rehabilitation work. The proposal would also expand the list of waterways subject to the inland waterways excise tax.

The proposal would be effective for vessels used in commercial waterway transportation beginning after September 30, 2015.



## **OTHER INITIATIVES**

### **ALLOW OFFSET OF FEDERAL INCOME TAX REFUNDS TO COLLECT DELINQUENT STATE INCOME TAXES FOR OUT-OF-STATE RESIDENTS**

#### **Current Law**

Generally, the Treasury will provide a refund of any overpayment of Federal tax made by a taxpayer (by withholding or otherwise). The overpayment amount is reduced by (i.e., offset by) debts of the taxpayer for past-due child support, debts to Federal agencies, fraudulently obtained unemployment compensation, and past-due, legally enforceable State income tax obligations. In the latter case, a refund offset is permitted only if the delinquent taxpayer resides in the State seeking the offset.

#### **Reasons for Change**

Under current law, a delinquent taxpayer can escape offset of a Federal refund for a State tax liability as long as the taxpayer is not a resident of the State. Foreclosing this possibility would better leverage the capacity of the Federal tax refund offset program for the country as a whole.

#### **Proposal**

The proposal would permit offset of Federal refunds to collect State income tax, regardless of where the delinquent taxpayer resides.

The proposal would be effective on the date of enactment.

## **AUTHORIZE THE LIMITED SHARING OF BUSINESS TAX RETURN INFORMATION TO IMPROVE THE ACCURACY OF IMPORTANT MEASURES OF THE ECONOMY**

### **Current Law**

Current law authorizes the IRS to disclose certain Federal tax information (FTI) for governmental statistical use. Business FTI may be disclosed to officers and employees of the Census Bureau for all businesses. Similarly, business FTI may be disclosed to officers and employees of the Bureau of Economic Analysis (BEA), but only for corporate businesses. Specific items permitted to be disclosed are detailed in the associated Treasury Regulations. The Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI.

### **Reasons for Change**

BEA's limited access to business FTI and BLS's lack of access to business FTI prevents BEA, BLS, and Census from synchronizing their business lists. Synchronization of business lists would significantly improve the consistency and quality of sensitive economic statistics including productivity, payroll, employment, and average hourly earnings.

In addition, given the growth of non-corporate businesses, especially in the service sector, the current limitation on BEA's access to corporate FTI impedes the measurement of income and international transactions in the National Accounts. The accuracy and consistency of income data are important to the formulation of fiscal policies.

Further, the Census's Business Register is constructed using both FTI and non-tax business data derived from the Economic Census and current economic surveys. Because this non-tax business data is inextricably commingled with FTI, it is not possible for Census to share data with BEA and BLS in any meaningful way.

### **Proposal**

The proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than \$250,000 and of all partnerships. BEA contractors would not have access to FTI.

The proposal would also give officers and employees of BLS access to certain business (and tax-exempt entities) FTI including: TIN; name(s) of the business; business address (mailing address and physical location); principal industry activity (including business description); number of employees and total business-level wages (including wages, tips, and other compensation, quarterly from Form 941 and annually from Forms 943 and 944); and sales revenue for employer businesses only. BLS would not have access to individual employee FTI. In other words, the proposal would allow officers and employees of each of BLS, BEA, and Census to access the same FTI for businesses, and would permit BLS, BEA, and Census to share such FTI amongst themselves (subject to the restrictions described below).

For the purpose of synchronizing BLS and Census business lists, the proposal would permit employees of State agencies to receive from BLS the following FTI identity items: TIN, business name(s), business address(es), and principal industry activity (including business description). No BLS contractor or State agency contractor would have access to FTI.

The proposal would require any FTI to which BEA and BLS would have access, either directly from IRS, from Census, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act (CIPSEA). The three statistical agencies and State agencies would be subject to taxpayer privacy law, safeguards, and penalties. They would also be subject to CIPSEA confidentiality safeguard procedures, requirements, and penalties. Conforming amendments to applicable statutes would be made as necessary to apply the taxpayer privacy law, including safeguards and penalties to BLS as well as Census and BEA. BLS would be required to monitor compliance by State agencies with the prescribed safeguard protocols.

The proposal would be effective upon enactment.

## **ELIMINATE CERTAIN REVIEWS CONDUCTED BY THE U.S. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (TIGTA)**

### **Current Law**

Section 7803(d) requires TIGTA to conduct reviews of certain administrative and civil actions and reviews of IRS compliance with respect to certain requirements in order to comply with TIGTA's reporting requirements.

### **Reasons for Change**

The statutory reviews that are proposed to be eliminated are of relatively low value and yield little in the way of performance measures. In order to make more efficient use of TIGTA's resources, TIGTA would prefer to redirect the resources applied to conduct these reviews to conducting high-risk audits.

### **Proposal**

As requested by TIGTA, the proposal would eliminate TIGTA's obligation to report information regarding any administrative or civil actions related to Fair Tax Collection Practices violations in one of TIGTA's Semiannual Reports, review and certify annually that the IRS is complying with the requirements of section 6103(e)(8) regarding information on joint filers, and annually report on the IRS's compliance with sections 7521(b)(2) and (c) requiring IRS employees to stop a taxpayer interview whenever a taxpayer requests to consult with a representative and to obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative has unreasonably delayed the completion of an examination or investigation.

The proposal would revise the annual reporting requirement for all remaining provisions in the IRS Restructuring and Reform Act of 1998 to a biennial reporting requirement.

The proposal would be effective after December 31, 2015.

## **MODIFY INDEXING TO PREVENT DEFLATIONARY ADJUSTMENTS**

### **Current Law**

Many parameters of the tax system—including the size of personal exemptions and standard deductions, the width of income tax rate brackets, the amount of certain other deductions and credits, and the maximum amount of various saving and retirement deductions—may be adjusted annually for the effects of inflation. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for all Urban Consumers (CPI-U). Depending on the particular tax parameter, the adjustment may be based on CPI-U for a particular month, its average for a calendar quarter, or its average for a 12-month period (with various ending dates). The adjusted values are rounded differently, as specified in the Code.

When inflation adjustment of tax parameters was enacted, it was generally expected that indexing would always result in upward adjustments to reflect inflation. Thus, if price levels decline for the year, mechanical application of the inflation adjustment provisions for most adjusted tax parameters permit the tax parameters to become smaller, so long as they do not decline to less than their base period values specified in the Code. However, the statutory provisions for the indexing of those tax parameters adjusted pursuant to section 415(d) (generally relating to benefits and contributions under qualified plans) are held at their previous year's level if the relevant price index declines. In subsequent years, they increase only to the extent that the relevant price index exceeds its highest preceding relevant level.

### **Reasons for Change**

Between 2008 and 2009, for the first time since inflation adjustments were enacted, the annual index values used for two of the indexing methods declined for the relevant annual period. The index level relevant for section 415(d) adjustments fell, but by statute those parameters remain at their 2009 levels for 2010. (They did not increase for 2011.) Also, the maximum size of a cash method debt instrument, as adjusted under section 1274A(d)(2) decreased for 2010. Other tax parameters did not decrease, since the price index relevant for their adjustments did not decline between 2008 and 2009.

The 2008 to 2009 price index changes demonstrate that a year-to-year decrease is possible. Preventing tax parameters from falling if the underlying price levels fall would make the tax system a more effective automatic economic stabilizer than it is under current law. Holding tax parameters constant would also prevent reductions in certain tax benefits for saving and retirement which should not be affected by short-term price level reductions.

### **Proposal**

The proposal would modify inflation adjustment provisions to prevent tax parameters from declining from the previous year's levels if the underlying price index falls. Future inflation-related increases would be based on the highest previous level of the price index relevant for adjusting the particular tax parameter.

The proposal would be effective beginning on the date of enactment.

**TABLES OF REVENUE ESTIMATES**

**Table 1: ADJUSTMENTS TO THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT (BBEDCA) BASELINE**

(fiscal years, in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
<b>Adjustments to the BBEDCA Baseline:</b>													
Permanently extend increased refundability of the child tax credit 1/ .....	0	0	0	-546	-10,919	-10,985	-11,099	-11,123	-11,085	-11,267	-11,296	-22,450	-78,320
Permanently extend Earned Income Tax Credit (EITC) for larger families and married couples:													
<i>Permanently extend EITC marriage penalty relief 1/</i> .....	0	0	0	-93	-1,439	-1,419	-1,469	-1,501	-1,505	-1,524	-1,561	-2,951	-10,511
<i>Permanently extend EITC for larger families 1/</i> .....	0	0	0	-105	-1,997	-2,015	-2,077	-2,130	-2,164	-2,207	-2,261	-4,117	-14,956
Subtotal, permanently extend EITC for larger families and married couples .....	0	0	0	-198	-3,436	-3,434	-3,546	-3,631	-3,669	-3,731	-3,822	-7,068	-25,467
Permanently extend the American Opportunity Tax Credit (AOTC) 1/ .....	0	0	0	-533	-7,418	-9,776	-9,446	-9,277	-8,995	-8,599	-8,433	-17,727	-62,477
<b>Total, Adjustments to the BBEDCA Baseline</b> .....	<b>0</b>	<b>0</b>	<b>0</b>	<b>-1,277</b>	<b>-21,773</b>	<b>-24,195</b>	<b>-24,091</b>	<b>-24,031</b>	<b>-23,749</b>	<b>-23,597</b>	<b>-23,551</b>	<b>-47,245</b>	<b>-166,264</b>
Total receipt effect .....	0	0	0	-565	-5,444	-5,271	-4,896	-4,704	-4,419	-4,015	-3,815	-11,280	-33,129
Total outlay effect .....	0	0	0	712	16,329	18,924	19,195	19,327	19,330	19,582	19,736	35,965	133,135

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Notes:

1/ This proposal affects both receipts and outlays. Both effects are shown above. The outlay effects included in these estimates are listed below.

Permanently extend increased refundability of the child tax credit .....	0	547	10,921	10,987	11,100	11,124	11,086	11,268	11,298	11,268	11,298	22,455	78,331
Permanently extend EITC marriage penalty relief .....	0	0	67	1,334	1,311	1,355	1,380	1,394	1,379	1,394	1,427	2,712	9,647
Permanently extend EITC for larger families .....	0	0	98	1,970	1,984	2,044	2,093	2,124	2,124	2,165	2,217	4,052	14,695
Permanently extend the AOTC .....	0	0	0	0	2,104	4,642	4,696	4,730	4,741	4,755	4,794	6,746	30,462
Total outlay effect .....	0	0	0	712	16,329	18,924	19,195	19,327	19,330	19,582	19,736	35,965	133,135

**Table 2: RESERVE FOR BUSINESS TAX REFORM THAT IS REVENUE NEUTRAL IN THE LONG RUN 1/**

(fiscal years, in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25	2016-30
<b>Reform the U.S. international tax system:</b>														
Restrict deductions for excessive interest of members of financial reporting groups .....	0	2,566	4,533	4,987	5,485	6,034	6,637	7,301	8,031	8,834	9,718	23,605	64,126	
Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas .....	0	-13	-22	-23	-24	-25	-25	-27	-28	-29	-31	-107	-247	
Repeat delay in the implementation of worldwide interest allocation .....	0	-1,352	-2,308	-2,400	-2,496	-2,596	-1,055	0	0	0	0	-11,152	-12,207	
Extend the exception under subpart F for active financing income .....	0	-4,081	-7,006	-7,356	-7,724	-8,110	-8,516	-8,942	-9,389	-9,858	-10,351	-34,277	-81,333	
Extend the look-through treatment of payments between related controlled foreign corporations (CFC) .....	0	-488	-838	-880	-924	-971	-1,019	-1,070	-1,124	-1,180	-1,239	-4,101	-9,733	
Impose a 19-percent minimum tax on foreign income .....	0	11,881	19,710	19,873	20,246	20,633	21,200	21,799	22,675	23,478	24,481	92,343	205,976	
Impose a 14-percent one-time tax on previously untaxed foreign income 2/ ..														
Limit shifting of income through intangible property transfers .....														
Disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates .....	0	88	167	201	237	275	315	361	413	473	542	968	3,072	
Modify tax rules for dual capacity taxpayers .....	0	346	616	667	708	744	784	829	863	897	934	3,081	7,388	
Tax gain from the sale of a partnership interest on look-through basis .....	0	533	914	956	999	1,043	1,089	1,119	1,168	1,220	1,274	4,445	10,315	
Modify sections 338(h)(16) and 902 to limit credits when non-double taxation exists:														
Extend section 338(h)(16) to certain asset acquisitions .....	0	42	70	70	70	70	70	70	70	70	70	322	672	
Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated .....	0	13	25	32	35	35	35	35	35	36	36	140	317	
Subtotal, modify sections 338(h)(16) and 902 to limit credits when non-double taxation exists .....	0	55	95	102	105	105	105	105	105	106	106	462	989	
Close loopholes under subpart F:														
Create a new category of subpart F income for transactions involving digital goods or services .....	0	437	750	787	827	868	912	957	1,005	1,055	1,108	3,669	8,706	
Expand foreign base company sales income to include manufacturing service arrangements .....	0	922	1,563	1,663	1,744	1,832	1,924	2,020	2,121	2,227	2,339	7,744	18,375	
Amend CFC attribution rules .....	0	30	83	141	205	275	351	435	525	624	731	734	3,400	
Eliminate the 30-day grace period before subpart F inclusions .....	0	60	103	108	114	119	125	131	138	145	152	504	1,195	
Subtotal, close loopholes under subpart F .....	0	1,449	2,519	2,699	2,890	3,094	3,312	3,543	3,789	4,051	4,330	12,651	31,676	
Restrict the use of hybrid arrangements that create stateless income:														
Restrict the use of hybrid arrangements that create stateless income .....	0	45	80	88	97	107	117	129	142	156	172	417	1,133	
Limit the application of exceptions under subpart F for certain transactions that use reverse hybrids to create stateless income .....	0	71	121	127	133	139	147	154	162	170	178	591	1,402	
Subtotal, restrict the use of hybrid arrangements that create stateless income .....	0	116	201	215	230	246	264	283	304	326	350	1,008	2,535	
Limit the ability of domestic entities to expatriate .....	0	113	311	530	769	1,031	1,317	1,630	1,970	2,340	2,743	2,754	12,754	
Subtotal, reform the U.S. international tax system .....	0	11,396	19,145	19,837	20,780	21,796	24,716	27,254	29,116	31,014	33,231	92,954	238,285	
<b>Simplification and tax relief for small business:</b>														
Expand and permanently extend increased expensing for small business .....	-7,200	-10,941	-8,935	-7,300	-6,254	-5,502	-5,108	-4,968	-4,896	-4,929	-5,012	-38,932	-63,845	
Expand simplified accounting for small business and establish a uniform definition of small business for accounting methods .....	0	-5,812	-3,809	-1,443	-762	-507	-492	-493	-488	-479	-472	-12,333	-14,757	
Eliminate capital gains taxation on investments in small business stock .....	0	0	0	0	0	-206	-710	-1,277	-1,811	-2,342	-2,869	-206	-9,215	
Increase the limitations for deductible new business expenditures and consolidate provisions for start-up and organizational expenditures .....	0	-359	-446	-440	-434	-431	-428	-426	-423	-419	-415	-2,110	-4,221	
Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance 3/ .....	-24	-305	-328	-218	-174	-148	-102	-113	-76	-60	-26	-1,173	-1,550	
Subtotal, simplification and tax relief for small business .....	-7,224	-17,417	-13,518	-9,401	-7,624	-6,794	-6,840	-7,277	-7,694	-8,229	-8,794	-54,754	-93,588	
<b>Incentives for manufacturing, research, and clean energy:</b>														
Enhance and make permanent research incentives .....	-3,552	-7,529	-9,290	-10,356	-11,389	-12,396	-13,387	-14,370	-15,352	-16,336	-17,327	-50,960	-127,732	



	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Extend and modify certain employment tax credits, including incentives for hiring veterans	-403	-796	-885	-950	-997	-1,033	-1,074	-1,121	-1,167	-1,210	-1,255	-4,661	-10,488
Modify and permanently extend renewable electricity production tax credit and investment tax credit 3/	0	596	-869	-2,323	-2,775	-3,283	-3,695	-4,075	-4,524	-4,991	-5,513	-8,654	-31,452
Modify and permanently extend the deduction for energy-efficient commercial building property	0	-170	-256	-294	-302	-298	-290	-280	-270	-260	-252	-1,320	-2,672
Provide a carbon dioxide investment and sequestration tax credit 3/	0	0	0	-174	-1,094	-1,149	-600	-466	-495	-521	-541	-2,417	-5,040
Provide additional tax credits for investment in qualified property used in a qualifying advanced energy manufacturing project	0	0	-73	-192	-1,111	-772	-94	14	48	40	37	-2,148	-2,103
Provide new Manufacturing Communities Tax Credit	0	-87	-256	-457	-600	-683	-745	-784	-689	-447	-145	-2,083	-4,893
Extend the tax credit for second generation biofuel production	-35	-80	-119	-149	-163	-175	-183	-158	-113	-65	-18	-686	-1,223
<b>Subtotal, incentives for manufacturing, research, and clean energy</b>	<b>-3,990</b>	<b>-8,066</b>	<b>-11,748</b>	<b>-14,895</b>	<b>-18,431</b>	<b>-19,789</b>	<b>-20,068</b>	<b>-21,240</b>	<b>-22,562</b>	<b>-23,790</b>	<b>-25,014</b>	<b>-72,929</b>	<b>-185,603</b>
<b>Incentives to promote regional growth:</b>													
Modify and permanently extend the New Markets Tax Credit	-18	-119	-289	-491	-720	-968	-1,226	-1,470	-1,605	-1,620	-1,586	-2,587	-10,094
Reform and expand the Low-Income Housing Tax Credit (LIHTC):													
Allow conversion of private activity bond volume cap into LIHTCs	0	-7	-37	-117	-210	-314	-403	-497	-590	-694	-797	-685	-3,666
Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income													
Change formulas for 70 percent present value and 30 percent present value LIHTCs	0	-1	-3	-8	-14	-18	-22	-25	-30	-33	-37	-44	-191
Add preservation of federally assisted affordable housing to allocation criteria													
Remove the qualified Census tract population cap	0	-1	-2	-5	-9	-13	-16	-19	-21	-24	-26	-30	-136
Implement requirement that LIHTC-supported housing protect victims of domestic abuse													
Subtotal, reform and expand LIHTC	0	-9	-42	-130	-233	-345	-441	-541	-641	-751	-860	-759	-3,993
<b>Subtotal, incentives to promote regional growth</b>	<b>-18</b>	<b>-128</b>	<b>-331</b>	<b>-621</b>	<b>-953</b>	<b>-1,313</b>	<b>-1,667</b>	<b>-2,011</b>	<b>-2,246</b>	<b>-2,371</b>	<b>-2,446</b>	<b>-3,346</b>	<b>-14,087</b>
<b>Incentives for investment in infrastructure:</b>													
Provide America Fast Forward Bonds (AFFB) and expand eligible uses:													
Provide AFFB and expand eligible uses 3/	0	0	-1	0	1	0	0	0	0	0	1	0	1
Allow eligible use of AFFB to include financing all qualified private activity bond program categories 3/	0	-1	4	-11	-15	-22	-28	-35	-41	-48	-54	-53	-259
Subtotal, provide AFFB and expand eligible uses	0	-1	-5	-11	-14	-22	-28	-35	-41	-48	-53	-53	-258
Allow current refundings of State and local governmental bonds	0	-1	-5	-5	-5	-5	-5	-5	-5	-5	-5	-21	-46
Repeal the \$150 million non-hospital bond limitation on qualified section 501(c)(3) bonds	0	0	-1	-3	-5	-7	-9	-11	-13	-16	-17	-16	-82
Increase national limitation amount for qualified highway or surface freight transfer facility bonds	-6	-28	-60	-93	-125	-153	-167	-163	-136	-96	-55	-459	-1,076
Provide a new category of qualified private activity bonds for infrastructure projects referred to as "Qualified Public Infrastructure Bonds"	0	-25	-117	-251	-386	-524	-638	-695	-714	-733	-751	-1,303	-4,834
Modify qualified private activity bonds for public education facilities													
Modify treatment of banks investing in tax-exempt bonds	0	-5	-38	-131	-225	-317	-405	-493	-574	-630	-616	-716	-3,434
Repeal tax-exempt bond financing of professional sports facilities	0	3	11	23	35	47	60	72	85	97	109	119	542
Allow more flexible research arrangements for purposes of private business use limits	0	0	0	0	-1	-1	-1	-3	-3	-3	-4	-2	-16
Modify tax-exempt bonds for Indian tribal governments	0	-4	-12	-12	-12	-12	-12	-12	-12	-12	-12	-52	-112
Exempt foreign pension funds from the application of the Foreign Investment in Real Property Tax Act	0	-120	-206	-216	-227	-238	-250	-263	-276	-290	-304	-1,007	-2,390
<b>Subtotal, incentives for investment in infrastructure</b>	<b>-6</b>	<b>-181</b>	<b>-433</b>	<b>-699</b>	<b>-965</b>	<b>-1,232</b>	<b>-1,455</b>	<b>-1,608</b>	<b>-1,689</b>	<b>-1,736</b>	<b>-1,708</b>	<b>-3,510</b>	<b>-11,706</b>
<b>Eliminate fossil fuel tax preferences:</b>													
Eliminate fossil fuel tax preferences:	0	0	0	0	0	0	0	0	0	0	0	0	0
Eliminate oil and natural gas preferences:	0	0	0	0	0	0	0	0	0	0	0	0	0
Repeal enhanced oil recovery credit 4/	0	0	0	0	0	0	0	0	0	0	0	0	0
Repeal credit for oil and natural gas produced from marginal wells 4/	0	0	0	0	0	0	0	0	0	0	0	0	0

**Table 2: RESERVE FOR BUSINESS TAX REFORM THAT IS REVENUE NEUTRAL IN THE LONG RUN 1/ -- continued**

(fiscal years, in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Repeal expensing of intangible drilling costs .....	0	2,267	3,182	2,351	1,867	1,566	1,243	848	695	723	753	11,233	15,495
Repeal deduction for tertiary injectants .....	0	7	10	10	10	10	10	10	10	10	10	47	97
Repeal exception to passive loss limitation for working interests in oil and natural gas properties .....	0	9	17	19	20	20	20	20	20	20	20	85	185
Repeal percentage depletion for oil and natural gas wells .....	0	1,118	1,790	1,669	1,585	1,498	1,375	1,246	1,122	994	856	7,660	13,253
Repeal domestic manufacturing deduction for oil and natural gas production .....	0	647	1,115	1,139	1,173	1,208	1,242	1,280	1,321	1,366	1,413	5,282	11,904
Increase geological and geophysical amortization period for independent producers to seven years .....	0	91	341	537	532	440	337	226	147	125	100	1,941	2,876
Subtotal, eliminate oil and natural gas preferences .....	0	4,139	6,455	5,725	5,187	4,742	4,227	3,630	3,315	3,238	3,152	26,248	43,810
Eliminate coal preferences:													
Repeal expensing of exploration and development costs .....	0	40	68	70	74	77	77	75	73	71	69	329	694
Repeal percentage depletion for hard mineral fossil fuels .....	0	183	299	288	278	266	254	241	228	214	199	1,314	2,450
Repeal capital gains treatment for royalties .....	0	27	54	53	54	55	58	61	61	62	62	243	547
Repeal domestic manufacturing deduction for the production of coal and other hard mineral fossil fuels .....	0	45	48	50	53	54	57	59	62	65	68	250	561
Subtotal, eliminate coal preferences .....	0	295	469	461	459	452	446	436	424	412	398	2,136	4,252
Treat publicly-traded partnerships for fossil fuels as C corporations .....	0	0	0	0	0	0	303	322	341	358	375	0	1,699
<b>Subtotal, eliminate fossil fuel tax preferences .....</b>	<b>0</b>	<b>4,434</b>	<b>6,924</b>	<b>6,186</b>	<b>5,646</b>	<b>5,194</b>	<b>4,976</b>	<b>4,388</b>	<b>4,080</b>	<b>4,008</b>	<b>3,925</b>	<b>28,384</b>	<b>49,761</b>
<b>Reform the treatment of financial and insurance industry products:</b>													
Require that derivative contracts be marked to market with resulting gain or loss treated as ordinary .....	0	2,926	4,769	4,138	2,731	1,733	1,186	731	531	535	516	16,297	19,796
Modify rules that apply to sales of life insurance contracts .....	0	23	43	46	48	50	54	56	58	61	63	210	502
Modify proration rules for life insurance company general and separate accounts .....	0	385	676	722	762	792	816	836	843	849	862	3,337	7,543
Expand pro rata interest expense disallowance for corporate-owned life insurance .....	0	65	159	252	364	492	641	809	980	1,160	1,357	1,332	6,279
Conform net operating loss rules of life insurance companies to those of other corporations .....	0	15	27	29	30	32	34	36	37	39	40	133	319
<b>Subtotal, reform the treatment of financial and insurance industry products .....</b>	<b>0</b>	<b>3,414</b>	<b>5,674</b>	<b>5,187</b>	<b>3,935</b>	<b>3,099</b>	<b>2,731</b>	<b>2,468</b>	<b>2,449</b>	<b>2,644</b>	<b>2,838</b>	<b>21,309</b>	<b>34,439</b>
<b>Other revenue changes and loophole closers:</b>													
Repeal last-in, first-out method of accounting for inventories .....	0	5,505	7,866	7,812	8,012	7,908	8,070	7,752	7,644	7,931	7,592	37,103	76,092
Repeal lower-of-cost-or-market inventory accounting method .....	0	743	1,491	1,501	1,511	889	266	278	291	304	317	6,135	7,591
Modify like-kind exchange rules for real property and collectibles .....	0	659	2,005	2,026	2,048	2,070	2,094	2,119	2,145	2,174	2,202	8,808	19,542
Modify depreciation rules for purchases of general aviation passenger aircraft .....	0	108	338	499	531	596	593	395	198	139	141	2,072	3,538
Expand the definition of substantial built-in loss for purposes of partnership loss transfers .....	0	6	7	7	7	7	8	8	10	10	10	34	80
Extend partnership basis limitation rules to nondeductible expenditures .....	0	69	97	102	105	108	110	112	114	116	118	481	1,051
Limit the importation of losses under related party loss limitation rules .....	0	63	87	92	95	97	99	100	102	104	106	434	945
Deny deduction for punitive damages .....	0	30	43	44	45	46	47	48	49	51	52	208	455
Conform corporate ownership standards .....	0	1	17	32	33	34	35	36	38	40	42	117	308
Tax corporate distributions as dividends:													
Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions .....	0	13	23	23	24	25	26	27	28	30	31	108	250
Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment .....	0	3	5	5	6	6	6	6	7	7	7	25	58
Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions .....	0	32	54	58	60	63	66	70	73	76	80	267	632
Repeal gain limitation for dividends received in reorganization exchanges .....	0	48	82	86	90	94	98	103	108	113	118	400	940
Subtotal, tax corporate distributions as dividends .....	0	48	82	86	90	94	98	103	108	113	118	400	940

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Repeal Federal Insurance Contributions Act tip credit .....	0	480	993	1,062	1,137	1,216	1,301	1,389	1,483	1,581	1,687	4,888	12,329
Repeal the excise tax credit for distilled spirits with flavor and wine additives .....	0	85	112	112	112	112	112	112	112	112	112	533	1,093
<b>Subtotal, other revenue changes and loophole closers .....</b>	<b>0</b>	<b>7,797</b>	<b>13,138</b>	<b>13,375</b>	<b>13,726</b>	<b>13,177</b>	<b>12,833</b>	<b>12,452</b>	<b>12,294</b>	<b>12,675</b>	<b>12,497</b>	<b>61,213</b>	<b>123,964</b>
<b>Total, Reserve for Business Tax Reform that is Revenue Neutral in the Long Run .....</b>	<b>-11,238</b>	<b>1,249</b>	<b>18,851</b>	<b>18,969</b>	<b>16,114</b>	<b>14,138</b>	<b>15,226</b>	<b>14,426</b>	<b>13,748</b>	<b>14,215</b>	<b>14,529</b>	<b>69,321</b>	<b>141,465</b>
Total receipt effect .....	-11,232	1,631	20,336	22,054	21,618	21,396	23,729	24,648	25,888	28,294	30,555	87,035	220,149
Total outlay effect .....	6	382	1,485	3,085	5,504	7,258	8,503	10,222	12,140	14,079	16,026	17,714	78,684

Department of the Treasury

Notes:

1/ Presentation in this table does not reflect the order in which these proposals were estimated.

2/ The Administration believes that this proposal should be enacted in the context of comprehensive business tax reform that is revenue neutral in the long run. However, the proposal generates one-time transition revenue in the short run, which the Budget proposes to dedicate to surface transportation reauthorization. Therefore, the effect of the proposal on receipts, shown below, is also included in the Budget proposals presented in Table 3 and is counted in the Budget's receipts and deficit totals.

3/ This proposal affects both receipts and outlays. Both effects are shown above. The outlay effects included in these estimates are listed below.

Expand and simplify the tax credit provided to qualified small employers	0	34,559	56,407	54,420	52,434	50,448	19,861	0	0	0	0	248,268	268,129
for non-elective contributions to employee health insurance .....	6	76	68	32	23	21	11	10	8	8	4	220	261
Modify and permanently extend renewable electricity production tax credit and investment tax credit .....	0	0	20	47	63	71	78	83	90	95	101	201	648
Provide a carbon dioxide investment and sequestration tax credit .....	0	0	0	0	729	728	170	28	48	65	76	1,457	1,844
Provide AFFB and expand eligible uses .....	0	253	1,154	2,483	3,874	5,319	6,811	8,345	9,909	11,492	13,090	13,083	62,730
Allow eligible uses of AFFB to include financing all qualified private activity bond program categories .....	0	53	243	523	815	1,119	1,433	1,756	2,085	2,419	2,755	2,753	13,201
Total outlay effect .....	6	382	1,485	3,085	5,504	7,258	8,503	10,222	12,140	14,079	16,026	17,714	78,684

4/ This provision is estimated to have zero receipt effect under the Administration's current economic projections.

**Table 3: BUDGET PROPOSALS 1/ 2/**

(fiscal years, in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25	2016-30
<b>Tax reform for families and individuals:</b>														
Reform child care tax incentives 3/ .....	0	-4,024	-4,191	-4,429	-4,639	-4,841	-5,052	-5,292	-5,532	-5,615	-6,257	-22,124	-22,124	-49,872
Simplify and better target tax benefits for education: Expand and modify the AOTC and repeal Lifetime Learning Credits 3/ .....	0	25	-869	-2,651	-2,661	-3,114	-3,454	-4,103	-4,387	-4,995	-5,084	-9,270	-9,270	-31,293
Make Pell Grants excludable from income 3/ .....	0	-30	-1,041	-2,182	-2,105	-2,050	-2,052	-2,031	-2,035	-2,032	-1,997	-7,408	-7,408	-17,555
Modify reporting of tuition expenses and scholarships on Form 1098-T 3/ ..	0	5	51	63	65	67	70	72	73	75	77	251	251	618
Repeal the student loan interest deduction and provide exclusion for certain debt relief and scholarships 3/ .....	0	-5	-13	-14	-14	-15	73	169	259	345	463	-61	-61	1,248
Repeal Coverdells and reduce the Federal tax benefits of qualified tuition programs .....	0	0	11	31	55	85	121	163	212	270	336	182	182	1,284
Subtotal, simplify and better target tax benefits for education .....	0	-5	-1,861	-4,753	-4,660	-5,027	-5,242	-5,730	-5,878	-6,337	-6,205	-16,306	-16,306	-45,698
Provide for automatic enrollment in IRAs, including a small employer tax credit, increase the tax credit for small employer plan start-up costs, and provide an additional tax credit for small employer plans newly offering auto-enrollment 3/ .....	0	0	-993	-1,589	-1,700	-1,754	-1,831	-2,005	-2,176	-2,410	-2,661	-6,036	-6,036	-17,119
Expand penalty-free withdrawals for long-term unemployed .....	0	-162	-235	-240	-245	-250	-255	-260	-265	-270	-276	-1,132	-1,132	-2,458
Require retirement plans to allow long-term part-time workers to participate ..	0	-39	-55	-54	-53	-52	-50	-47	-44	-40	-34	-253	-253	-468
Facilitate annuity portability .....	0	-5	-5	-3	4	14	30	51	74	105	142	5	5	407
Simplify minimum required distribution rules .....	0	-44	-593	-599	-588	-605	-620	-631	-642	-653	-678	-2,429	-2,429	-5,653
Allow all inherited plan and IRA balances to be rolled over within 60 days .....	0	-460	-6,256	-6,297	-6,350	-6,481	-6,612	-6,716	-6,804	-6,921	-7,047	-25,844	-25,844	-59,944
Expand the EITC for workers without qualifying children 3/ .....	0	-2,067	-9,007	-9,104	-9,383	-9,502	-9,727	-9,872	-9,936	-10,127	-10,306	-39,063	-39,063	-89,031
Simplify the rules for claiming the EITC for workers without qualifying children 3/ .....	0	-44	-593	-599	-588	-605	-620	-631	-642	-653	-678	-2,429	-2,429	-5,653
Provide a second-earner tax credit 3/ .....	0	-2,067	-9,007	-9,104	-9,383	-9,502	-9,727	-9,872	-9,936	-10,127	-10,306	-39,063	-39,063	-89,031
Extend exclusion from income for cancellation of certain home mortgage debt .....	-2,542	-3,265	-2,978	-724	0	0	0	0	0	0	0	-6,967	-6,967	-276,803
<b>Subtotal, tax reform for families and individuals .....</b>	<b>-2,542</b>	<b>-10,071</b>	<b>-26,174</b>	<b>-27,792</b>	<b>-27,614</b>	<b>-28,498</b>	<b>-29,359</b>	<b>-30,502</b>	<b>-31,203</b>	<b>-32,268</b>	<b>-33,322</b>	<b>-120,149</b>	<b>-120,149</b>	<b>-276,803</b>
<b>Reforms to capital gains taxation, upper-income tax benefits, and the taxation of financial institutions:</b>														
Reduce the value of certain tax expenditures .....	0	28,028	46,032	50,592	54,995	59,478	63,843	68,379	72,914	77,231	81,734	239,125	239,125	603,226
Reform the taxation of capital income .....	3,634	9,048	20,705	18,041	21,448	21,892	21,538	22,276	23,178	24,292	25,466	91,134	91,134	207,884
Implement the Buffett Rule by imposing a new "Fair Share Tax" .....	0	6,671	-93	1,178	2,810	3,695	3,872	4,008	4,177	4,351	4,507	14,261	14,261	35,176
Impose a financial fee .....	0	5,644	11,084	10,978	11,208	11,470	11,734	12,003	12,280	12,562	12,851	50,384	50,384	111,814
<b>Subtotal, reforms to capital gains taxation, upper-income tax benefits, and the taxation of financial institutions .....</b>	<b>3,634</b>	<b>49,391</b>	<b>77,728</b>	<b>80,789</b>	<b>90,461</b>	<b>96,535</b>	<b>100,987</b>	<b>106,666</b>	<b>112,549</b>	<b>118,436</b>	<b>124,558</b>	<b>394,904</b>	<b>394,904</b>	<b>958,100</b>
<b>Loophole closers:</b>														
Require current inclusion in income of accrued market discount and limit the accrual amount for distressed debt .....	0	4	12	20	27	34	41	49	58	68	78	97	97	391
Require that the cost basis of stock that is a covered security must be determined using an average cost basis method .....	0	0	69	209	353	507	597	620	645	673	702	1,138	1,138	4,375
Tax carried (profits) interests as ordinary income .....	0	1,294	2,417	2,421	2,316	2,204	2,094	1,692	1,271	1,036	953	10,652	10,652	17,698
Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years .....	0	87	237	400	567	737	786	748	694	640	583	2,028	2,028	5,479
Limit the total accrual of tax-favored retirement benefits .....	0	1,418	1,987	2,213	2,287	2,438	2,634	2,785	3,183	3,396	3,702	10,343	10,343	26,043
Conform Self-Employment Contribution Act taxes for professional service businesses .....	0	4,465	6,268	6,622	6,977	7,372	7,837	8,371	8,837	9,248	8,554	31,704	31,704	74,551
Limit Roth conversions to pre-tax dollars .....	0	0	14	23	24	38	49	50	51	67	79	99	99	395
Eliminate deduction for dividends on stock of publicly-traded corporations held in employee stock ownership plans .....	0	589	830	851	865	879	892	907	922	936	951	4,014	4,014	8,622
Repeal exclusion of net unrealized appreciation in employer securities .....	0	145	245	249	254	260	265	270	275	281	287	1,153	1,153	2,531

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Disallow the deduction for charitable contributions that are a prerequisite for purchasing tickets to college sporting events .....	0	<u>126</u>	<u>201</u>	<u>218</u>	<u>233</u>	<u>249</u>	<u>266</u>	<u>283</u>	<u>302</u>	<u>323</u>	<u>345</u>	<u>1,027</u>	<u>2,546</u>
<b>Subtotal, loophole closers .....</b>	<b>0</b>	<b>8,128</b>	<b>12,280</b>	<b>13,226</b>	<b>13,903</b>	<b>14,718</b>	<b>15,461</b>	<b>15,775</b>	<b>16,238</b>	<b>16,668</b>	<b>16,234</b>	<b>62,255</b>	<b>142,631</b>
<b>Incentives for job creation, clean energy, and manufacturing:</b>													
Designate Promise Zones 3/ .....	0	-604	-1,130	-1,010	-938	-890	-852	-813	-791	-792	-807	-4,572	-8,627
Provide a tax credit for the production of advanced technology vehicles .....	0	-581	-475	-512	-567	-507	-418	-299	6	197	209	-2,642	-2,947
Provide a tax credit for medium- and heavy-duty alternative-fuel commercial vehicles .....	0	-46	-76	-77	-80	-61	-26	-5	0	0	0	-340	-371
Modify and extend the tax credit for the construction of energy-efficient new homes .....	-60	-132	-164	-195	-227	-252	-270	-286	-302	-329	-341	-970	-2,498
Reduce excise taxes on liquefied natural gas to bring into parity with diesel ..	0	-4	-5	-6	-6	-6	-7	-7	-9	-9	-10	-27	-69
Enhance and modify the conservation easement deduction:													
<i>Permanently enhance incentives and reform the deduction for donations of conservation easements .....</i>	-59	-153	-102	-20	3	3	2	3	3	3	4	-269	-254
<i>Pilot an allocable credit for conservation contributions and report to Congress .....</i>	-5	-19	-25	-25	-25	-25	-25	-25	-25	-25	-25	-119	-244
<i>Eliminate the deduction for contributions of conservation easements on golf courses .....</i>	5	21	38	50	56	60	62	66	69	73	76	225	571
<i>Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation .....</i>	<u>2</u>	<u>7</u>	<u>13</u>	<u>17</u>	<u>20</u>	<u>21</u>	<u>22</u>	<u>23</u>	<u>24</u>	<u>25</u>	<u>27</u>	<u>78</u>	<u>199</u>
Subtotal, enhance and modify the conservation easement deduction .....	<u>-57</u>	<u>-144</u>	<u>-76</u>	<u>22</u>	<u>54</u>	<u>59</u>	<u>61</u>	<u>67</u>	<u>71</u>	<u>76</u>	<u>82</u>	<u>-85</u>	<u>272</u>
<b>Subtotal, incentives for job creation, clean energy, and manufacturing .....</b>	<b>-117</b>	<b>-1,511</b>	<b>-1,926</b>	<b>-1,778</b>	<b>-1,764</b>	<b>-1,657</b>	<b>-1,512</b>	<b>-1,343</b>	<b>-1,025</b>	<b>-857</b>	<b>-867</b>	<b>-8,636</b>	<b>-14,240</b>
<b>Modify estate and gift tax provisions:</b>													
Restore the estate, gift, and generation-skipping transfer (GST) tax parameters in effect in 2009 .....	0	0	14,611	15,938	17,310	18,723	20,444	22,230	24,261	26,612	29,182	66,582	189,311
Require consistency in value for transfer and income tax purposes .....	0	0	267	279	303	337	356	383	407	438	467	1,186	3,237
Modify transfer tax rules for grantor retained annuity trusts and other grantor trusts .....	0	0	1,054	1,198	1,359	1,574	1,892	2,294	2,637	3,073	3,273	5,185	18,354
Limit duration of GST tax exemption .....													
Extend the lien on estate tax deferrals where estate consists largely of interest in closely held business .....	0	0	23	23	24	25	27	29	31	32	34	95	248
Modify GST tax treatment of Health and Education Exclusion Trusts .....	0	0	-32	-31	-29	-28	-25	-24	-22	-21	-19	-120	-231
Simplify gift tax exclusion for annual gifts .....	0	0	78	155	217	320	389	428	517	618	724	770	3,446
Expand applicability of definition of executor .....													
<b>Subtotal, modify estate and gift tax provisions .....</b>	<b>0</b>	<b>0</b>	<b>16,001</b>	<b>17,562</b>	<b>19,184</b>	<b>20,951</b>	<b>23,083</b>	<b>25,340</b>	<b>27,831</b>	<b>30,752</b>	<b>33,661</b>	<b>73,698</b>	<b>214,365</b>
<b>Other revenue raisers:</b>													
Increase and modify Oil Spill Liability Trust Fund financing .....	0	105	150	155	160	165	168	176	177	181	191	735	1,628
Reinstate Superfund taxes:													
<i>Reinstate and extend Superfund excise taxes .....</i>	0	589	791	798	805	811	819	826	833	839	855	3,794	7,966
<i>Reinstate Superfund environmental income tax .....</i>	<u>0</u>	<u>996</u>	<u>1,257</u>	<u>1,282</u>	<u>1,305</u>	<u>1,315</u>	<u>1,341</u>	<u>1,379</u>	<u>1,426</u>	<u>1,468</u>	<u>1,508</u>	<u>6,155</u>	<u>13,277</u>
Subtotal, reinstate Superfund taxes .....	0	1,585	2,048	2,080	2,110	2,126	2,160	2,205	2,259	2,307	2,363	9,949	21,243
Increase tobacco taxes and index for inflation .....	0	8,434	10,826	10,663	10,633	10,301	9,860	9,403	8,850	8,342	7,830	50,857	95,142
Make unemployment insurance surtax permanent .....	0	1,108	1,527	1,552	1,575	1,596	1,620	1,643	1,669	1,695	1,701	7,358	15,686
Expand Federal Unemployment Tax Act base .....	<u>0</u>	<u>0</u>	<u>3,634</u>	<u>3,618</u>	<u>3,457</u>	<u>3,600</u>	<u>3,901</u>	<u>4,485</u>	<u>5,313</u>	<u>6,647</u>	<u>7,100</u>	<u>14,309</u>	<u>44,755</u>
<b>Subtotal, other revenue raisers .....</b>	<b>0</b>	<b>11,232</b>	<b>18,185</b>	<b>18,068</b>	<b>17,935</b>	<b>17,788</b>	<b>17,709</b>	<b>19,912</b>	<b>19,268</b>	<b>19,172</b>	<b>19,185</b>	<b>83,208</b>	<b>178,454</b>
<b>Reduce the tax gap and make reforms:</b>													
<b>Expand information reporting:</b>													
Improve information reporting for certain businesses and contractors:													
<i>Require a certified TIN from contractors and allow certain withholding .....</i>	0	16	39	64	88	92	96	100	105	109	114	299	823
<i>Require information reporting for private separate accounts of life insurance companies .....</i>	<u>0</u>	<u>0</u>	<u>0</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>3</u>	<u>8</u>
Subtotal, improve information reporting for certain businesses and contractors .....	0	16	39	65	89	93	97	101	106	110	115	302	831

**Table 3: BUDGET PROPOSALS 1/ 2/ -- continued**

(fiscal years, in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Provide an exception to the limitation on disclosing tax return information to expand TIN matching beyond forms where payments are subject to backup withholding													
Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act													
Improve mortgage interest deduction reporting	0	104	160	171	182	192	203	213	222	231	240	809	1,918
Require Form W-2 reporting for employer contributions to defined contribution plans													
Subtotal, expand information reporting	0	120	199	236	271	285	300	314	328	341	355	1,111	2,749
<b>Improve compliance by businesses:</b>													
Increase certainty with respect to worker classification	0	85	420	818	978	1,063	1,155	1,250	1,356	1,465	1,580	3,364	10,170
Increase information sharing to administer excise taxes	0	4	9	13	14	16	17	18	18	19	19	56	147
Provide authority to readily share information about beneficial ownership information of U.S. companies with law enforcement	0	0	1	2	9	6	4	3	3	3	3	18	34
Subtotal, improve compliance by businesses	0	89	430	833	1,001	1,085	1,176	1,271	1,377	1,487	1,602	3,438	10,351
<b>Strengthen tax administration:</b>													
Impose liability on shareholders to collect unpaid income taxes of applicable corporations	0	442	463	484	505	528	550	574	600	626	652	2,422	5,424
Increase levy authority for payments to Medicare providers with delinquent tax debt	0	34	50	50	51	52	54	54	56	56	57	237	514
Implement a program integrity statutory cap adjustment for tax administration	0	432	1,451	2,926	4,476	6,095	7,481	8,475	9,077	9,503	9,819	15,380	59,735
Streamline audit and adjustment procedures for large partnerships	0	190	252	249	242	236	238	243	248	253	256	1,169	2,407
Revise offer-in-compromise application rules	0	1	1	2	2	2	2	2	2	2	2	8	18
Expand IRS access to information in the National Directory of New Hires for tax administration purposes													
Make repeated willful failure to file a tax return a felony	0	0	0	0	1	1	1	1	2	2	2	2	10
Facilitate tax compliance with local jurisdictions	0	1	1	1	2	2	2	2	2	2	2	7	17
Extend statute of limitations for assessment of overstated basis and State adjustments	0	0	0	0	77	90	103	118	135	155	178	167	856
Improve investigative disclosure statute	0	0	0	0	1	1	1	1	2	2	2	2	10
Allow the IRS to absorb credit and debit card processing fees for certain tax payments	0	2	2	2	2	2	2	2	2	2	2	10	20
Provide the IRS with greater flexibility to address correctable errors 3/	0	30	62	64	65	65	67	68	71	72	75	286	639
Enhance electronic filing of returns	0	0	0	0	1	1	1	1	2	2	2	2	10
Improve the whistleblower program													
Index all civil tax penalties for inflation													
Extend IRS authority to require truncated Social Security Numbers on Form W-2													
Combat tax-related identity theft													
Allow States to send notices of intent to offset Federal tax refunds to collect State tax obligations by regular first-class mail instead of certified mail													
Rationalize tax return filing due dates so they are staggered 3/	0	-180	173	181	190	196	199	207	215	221	228	560	1,630
Increase oversight and due diligence of paid tax return preparers:													
Extend paid preparer EITC due diligence requirements to the child tax credit													
Explicitly provide that the Department of the Treasury and IRS have the authority to regulate all paid tax return preparers 3/	0	14	32	34	38	41	45	49	53	58	63	159	427
Increase the penalty applicable to paid tax return preparers who engage in willful or reckless conduct	0	0	0	1	1	1	1	1	1	1	1	3	8
Subtotal, increase oversight and due diligence of paid tax return preparers	0	14	32	35	39	42	46	50	54	59	64	162	435
Enhance administrability of the appraiser penalty													

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Subtotal, strengthen tax administration .....	0	966	2,487	3,994	5,654	7,313	8,747	9,798	10,468	10,957	11,341	20,414	71,725
<b>Subtotal, reduce the tax gap and make reforms .....</b>	<b>0</b>	<b>1,175</b>	<b>3,116</b>	<b>5,063</b>	<b>6,926</b>	<b>8,683</b>	<b>10,223</b>	<b>11,383</b>	<b>12,173</b>	<b>12,785</b>	<b>13,298</b>	<b>24,963</b>	<b>84,825</b>
<b>Simplify the tax system:</b>													
Modify adoption credit to allow tribal determination of special needs .....	0	0	0	0	0	0	-1	-1	-1	-1	-1	0	-5
Repeal non-qualified preferred stock designation .....	0	26	44	43	41	38	35	30	26	23	20	192	326
Repeal preferential dividend rule for publicly traded and publically offered real estate investment trusts .....	0	0	-6	-5	-5	-6	-6	-6	-6	-6	-7	-22	-53
Reform excise tax based on investment income of private foundations .....													
Remove bonding requirements for certain taxpayers subject to Federal excise taxes on distilled spirits, wine, and beer .....													
Simplify arbitrage investment restrictions .....	0	0	-2	-10	-18	-28	-38	-46	-58	-68	-76	-58	-344
Simplify single-family housing mortgage bond targeting requirements .....	0	0	-1	-3	-5	-7	-10	-12	-17	-20	-22	-16	-97
Streamline private business limits on governmental bonds .....	0	0	-1	-3	-5	-7	-9	-11	-13	-15	-17	-16	-81
Repeal technical terminations of partnerships .....	0	10	16	18	20	22	24	26	28	29	31	86	224
Repeal anti-churning rules of section 197 .....	0	-24	-99	-198	-281	-338	-370	-378	-378	-378	-378	-940	-2,822
Repeal special estimated tax payment provision for certain insurance companies .....													
Repeal the telephone excise tax .....	0	-296	-349	-308	-266	-225	-208	-161	-128	-80	-31	-1,444	-2,052
Increase the standard mileage rate for automobile use by volunteers .....	0	-15	-47	-48	-49	-50	-51	-52	-53	-55	-56	-209	-476
Consolidate contribution limitations for charitable deductions and extend the carryforward period for excess charitable contribution deduction amounts													
Exclude from gross income subsidies from public utilities for purchase of water runoff management .....	0	-88	-49	-5	-6	-6	-6	-482	-1,168	-1,801	-2,379	-154	-5,990
Provide relief for certain accidental dual citizens .....	0	-60	-103	-55	-23	-24	-25	-26	-28	-29	-30	-265	-403
<b>Subtotal, simplify the tax system .....</b>	<b>0</b>	<b>-447</b>	<b>-597</b>	<b>-574</b>	<b>-597</b>	<b>-631</b>	<b>-665</b>	<b>-1,119</b>	<b>-1,796</b>	<b>-2,401</b>	<b>-2,946</b>	<b>-2,846</b>	<b>-11,773</b>
<b>User fee:</b>													
Reform inland waterways funding .....	0	113	113	113	113	113	113	113	113	113	113	565	1,130
<b>Subtotal, user fee .....</b>	<b>0</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>113</b>	<b>565</b>	<b>1,130</b>
<b>Other initiatives:</b>													
Allow offset of Federal income tax refunds to collect delinquent State income taxes for out-of-state residents .....													
Authorize the limited sharing of business tax return information to improve the accuracy of important measures of the economy .....													
Eliminate certain reviews conducted by the U.S. Treasury Inspector General for Tax Administration .....													
Modify indexing to prevent deflationary adjustments .....													
<b>Subtotal, other initiatives .....</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Impose a 14-percent one-time tax on previously untaxed foreign income 4/ .....</b>	<b>0</b>	<b>34,559</b>	<b>56,407</b>	<b>54,420</b>	<b>52,434</b>	<b>50,448</b>	<b>19,861</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>248,268</b>	<b>268,129</b>
<b>Total, Budget Proposals .....</b>	<b>975</b>	<b>92,569</b>	<b>155,133</b>	<b>159,097</b>	<b>170,981</b>	<b>178,450</b>	<b>155,901</b>	<b>146,225</b>	<b>154,148</b>	<b>162,400</b>	<b>169,914</b>	<b>756,230</b>	<b>1,544,818</b>
Total receipt effect .....	975	93,765	164,803	171,875	183,824	191,512	169,495	160,271	168,647	177,281	185,031	805,779	1,666,504
Total outlay effect .....	0	1,196	9,670	12,778	12,843	13,062	13,594	14,046	14,499	14,881	15,117	49,549	121,686

Department of the Treasury

Notes:  
1/ Presentation in this table does not reflect the order in which these proposals were estimated.

2/ Table 12-4 in the Analytical Perspectives of the FY 2016 Budget includes the effects of a number of proposals that are not reflected here. These proposals would: reform the unemployment insurance (UI) extended benefits program, modernize the UI program, levy a fee on the production of hardrock minerals to restore abandoned mines, return fees on production of coal to pre-2006 levels to restore abandoned mines, enhance UI program integrity, reauthorize special domestic nuclear utilities, extend Generalized System of Preferences, extend African Growth Opportunity Act, extend the Children's Health Insurance Program through 2019, create State option to provide 12-month continuous Medicaid eligibility for adults, extend reserve depletion date for Social Security's Disability Insurance program, and enact comprehensive immigration reform.

3/ This proposal affects both receipts and outlays. Both effects are shown above. The outlay effects included in these estimates are listed below.

Reform child care tax incentives .....	0	932	969	1,014	1,066	1,107	1,139	1,190	1,231	1,227	1,265	5,088	11,140
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**Table 3: BUDGET PROPOSALS 1/ 2/ -- continued**

(fiscal years, in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Expand and modify the AOTC and repeal Lifetime Learning Credits .....	0	0	1,125	2,934	2,948	3,047	3,376	3,686	3,998	4,291	4,392	10,054	29,797
Make Pell Grants excludable from income .....	0	0	743	1,905	1,844	1,801	1,825	1,817	1,826	1,833	1,802	6,293	15,396
Modify reporting of tuition expenses and scholarships on Form 1098-T .....	0	0	-6	-17	-18	-19	-21	-22	-22	-23	-24	-60	-172
Repeal the student loan interest deduction and provide exclusion for certain debt relief and scholarships .....	0	0	0	0	0	0	-3	-10	-17	-26	-35	0	-91
Provide for automatic enrollment in IRAs, including a small employer tax credit, increase the tax credit for small employer plan start-up costs, and provide an additional tax credit for small employer plans newly offering auto-enrollment .....	0	0	127	195	200	209	212	215	220	225	229	731	1,832
Expand the EITC for workers without qualifying children .....	0	276	5,519	5,553	5,600	5,709	5,825	5,914	5,997	6,090	6,198	22,657	52,681
Simplify the rules for claiming the EITC for workers without qualifying children .....	0	26	522	527	517	532	545	555	565	574	596	2,124	4,959
Provide a second-earner tax credit .....	0	0	732	729	750	740	761	768	770	762	767	2,951	6,779
Designate Promise Zones .....	0	12	28	29	31	32	34	35	37	38	41	132	317
Provide the IRS with greater flexibility to address correctable errors .....	0	-26	-53	-54	-55	-55	-56	-57	-59	-60	-62	-243	-537
Rationalize tax return filing due dates so they are staggered .....	0	-22	-22	-22	-23	-23	-23	-24	-24	-25	-25	-112	-233
Explicitly provide that the Department of the Treasury and IRS have the authority to regulate all paid tax return preparers .....	0	-2	-14	-15	-17	-18	-20	-21	-23	-25	-27	-66	-182
Total outlay effect .....	0	1,196	9,670	12,778	12,843	13,062	13,594	14,046	14,499	14,881	15,117	49,549	121,686

4/ The Administration believes that this proposal should be enacted in the context of comprehensive business tax reform that is revenue neutral in the long run. However, the proposal generates one-time transition revenue in the short run, which the Budget proposes to dedicate to surface transportation reauthorization. Therefore, the effect of the proposal on receipts, shown here, is included in the Budget's receipts and deficit totals.