DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE CHAIRMAN'S MARK OF THE "TAX CUTS AND JOBS ACT"

Scheduled for Markup
Before the
SENATE COMMITTEE ON FINANCE
on November 15, 2017

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup of the Tax Cuts and Jobs Act on November 13, 2017.[1] This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Modification to the Chairman's Mark of the Tax Cuts and Jobs Act.

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

[2] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-56-17), November 14, 2017. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. PROPOSALS STRICKEN FROM THE CHAIRMAN'S MARK

The Chairman's modification strikes the following proposals:

- Item III.H.1, Nonqualified deferred compensation,
- Item III.K, Determination of worker classification and information reporting requirements,
- Item III.M.2, Application of 10-percent early withdrawal tax to governmental section 457(b) plans, and
- Item III.M.3, Elimination of catch-up contributions for high-wage employees.

II. PROPOSALS MODIFYING PROPOSALS IN THE CHAIRMAN'S MARK

A. Tax Reform for Individuals

1. Title I of the Chairman's mark to expire after December 31, 2025

Description of Modification

The Chairman's mark is modified by adding an expiration date to the proposals contained in Title I of the Chairman's mark. Under the modification, all of the proposals contained in Title I will expire after December 31, 2025. This does not apply to the proposal that requires the use of the chained CPI-U ("C-CPI-U") to index tax parameters currently indexed by the CPI-U. Additionally, this does not apply to the proposal that reduces the amount of the Affordable Care Act individual shared responsibility payment to zero.

In addition, under this proposal, the repeal of the individual alternative minimum tax expires after December 31, 2025.

Thus, under the modification, after December 31, 2025, the provisions of the Code changed by Title I of the Chairman's mark will revert to their form as existed prior to January 1, 2018. However, to the extent these provisions were indexed for inflation, the indexed values will continue to be indexed by applying chained CPI.

Effective Date

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

2. Modification of individual income tax rates

The Chairman's modification replaces the individual income tax rate structure with a new rate structure for taxable years beginning after December 31, 2017.

Table 1.–Proposed Federal Individual Income Tax Rates for 2018

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $70,000	$4,453.50 plus 22% of the excess over $38,700
Over $70,000 but not over $160,000	$11,339.50 plus 24% of the excess over $70,000
Over $160,000 but not over $200,000	$32,929.50 plus 32% of the excess over $160,000
Over $200,000 but not over $500,000	$45,739.50 plus 35% of the excess over $200,000
Over $500,000	$150,739.50 plus 38.5% of the excess over $500,000

If taxable income is:	Then income tax equals:
Heads of Households	
Not over $13,600	10% of the taxable income
Over $13,600 but not over $51,800	$1,360 plus 12% of the excess over $13,600
Over $51,800 but not over $70,000	$5,944 plus 22% of the excess over $51,800
Over $70,000 but not over $160,000	$9,948 plus 24% of the excess over $70,000
Over $160,000 but not over $200,000	$31,548 plus 32% of the excess over $160,000
Over $200,000 but not over $500,000	$44,348 plus 35% of the excess over $200,000
Over $500,000	$149,348 plus 38.5% of the excess over $500,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $19,050	10% of the taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $140,000	$8,907 plus 22% of the excess over $77,400
Over $140,000 but not over $320,000	$22,679 plus 24% of the excess over $140,000
Over $320,000 but not over $400,000	$65,879 plus 32% of the excess over $320,000
Over $400,000 but not over $1,000,000	$91,479 plus 35% of the excess over $400,000
Over $1,000,000	$301,479 plus 38.5% of the excess over $1,000,000
Married Individuals Filing Separate Returns	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $70,000	$4,453.50 plus 22% of the excess over $38,700
Over $70,000 but not over $160,000	$9,246 plus 24% of the excess over $70,000
Over $160,000 but not over $200,000	$30,496 plus 32% of the excess over $160,000
Over $200,000 but not over $500,000	$46,746 plus 35% of the excess over $200,000
Over $500,000	$153,496 plus 38.5% of the excess over $500,000
Estates and Trusts	
Not over $2,550	10% of the taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,011.50 plus 38.5% of the excess over $12,500

3. Modification of the child tax credit

The Chairman's modification increases the child tax credit to $2,000 and modifies the threshold amount where the credit begins to phase out to $500,000 for married taxpayers filing a joint return. This modification is effective for taxable years beginning after December 31, 2017.

4. Modification of 17.4 percent deduction for certain passthrough income

The Chairman's modification provides that in the case of a taxpayer who has qualified business income from a partnership, S corporation or sole proprietorship, the amount of the 17.4-percent deduction is generally limited to 50 percent of the taxpayer's allocable or pro rata share of W-2 wages of the partnership or S corporation or 50 percent of the W-2 wages of the sole proprietorship. W-2 wages of a partnership, S corporation, or sole proprietorship is the sum of wages subject to wage withholding, elective deferrals, and deferred compensation paid by the partnership, S corporation, or sole proprietorship during the calendar year ending during the taxable year. Under a special rule, the W-2 wage limit does not apply in the case of a taxpayer with taxable income not exceeding $500,000 for married individuals filing jointly or $250,000 for other individuals. The application of the W-2 wage limit is phased in for individuals with taxable income exceeding this $500,000 (or $250,000) amount over the next $100,000 of taxable income for married individuals filing jointly or $50,000 for other individuals.

The modification further provides that the exception allowing the 17.4-percent deduction in the case of certain taxpayers with income from a specified service business applies to those whose taxable income does not exceed $500,000 for married individuals filing jointly or $250,000 for other individuals. The benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for married individuals filing jointly or $50,000 for other individuals.

B. Business Tax Reform

1. Modification to the interest limitation for certain farms

The Chairman's modification revises the limitation on the deduction of business interest to allow a farming business (as defined in section 263A(e)(4)) to elect not to be subject to the limitation. The Chairman's modification requires a farming business electing not to be subject to the limitation to use the alternative depreciation system to depreciate any property used in the farming business with a recovery period of ten years or more.

2. Modification of temporary 100-percent expensing for certain business assets

The Chairman's modification expands the definition of qualified property eligible for the additional first-year depreciation allowance to include qualified film, television and live theatrical productions,[3] effective for productions placed in service after September 27, 2017, and before January 1, 2023. For this purpose, a production is considered placed in service at the time of initial release, broadcast, or live staged performance (*i.e.*, at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).

3. Modification of applicable recovery period for real property

The Chairman's modification shortens the alternative depreciation system recovery period for residential rental property from 40 years[4] to 30 years, effective for property placed in service after December 31, 2017.

4. Modification of net operating loss deduction

The Chairman's modification limits the net operating loss deduction to 80 percent of taxable income (determined without regard to the deduction) in taxable years beginning after December 31, 2023.

5. Modification of net operating loss deduction for property and casualty insurance companies

The Chairman's modification preserves present law for net operating losses ("NOLs") of property and casualty insurance companies. Under the modification, NOLs of property and casualty insurance companies may be carried back two years and carried over 20 years to offset 100 percent of taxable income in such years.

6. Modification of deduction for meals provided at convenience of the employer

The Chairman's modification disallows an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises,

[3] As defined in section 181(d) and (e).

[4] See sec. 168(g)(2).

or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

7. Transition rule added to modification of limitation on excessive employee remuneration

The Chairman's modification adds a transition rule in connection with the expansion of section 162(m) so that the proposed changes do not apply to any remuneration under a written binding contract which was in effect on November 2, 2017, and which was not modified after this date in any material respect, and to which the right of the covered employee was no longer subject to a substantial risk of forfeiture on or before December 31, 2016.

C. International Tax Reform

1. Modification to deduction for global intangible low-taxed income

The Chairman's modification reduces the proposal's deduction for global intangible low-taxed income from 50 percent to 37.5 percent for taxable years beginning after December 31, 2025. For taxable years beginning after December 31, 2017, and before January 1, 2026, the proposal's 50-percent deduction for global intangible low-taxed income is unchanged.

2. Modification to deduction for foreign-derived intangible income

The Chairman's modification reduces the proposal's deduction for foreign-derived intangible income from 37.5 percent to 21.875 percent for taxable years beginning after December 31, 2025. For taxable years beginning after December 31, 2017, and before January 1, 2026, the proposal's 37.5-percent deduction for foreign-derived intangible income is unchanged.

3. Election with respect to net operating losses and the treatment of deferred foreign income upon transition to participation exemption system

The Chairman's modification allows taxpayers to elect to preserve net operating losses and opt out of utilizing such net operating losses to offset the mandatory inclusion required of a U.S. shareholder under the transition proposal. The modification also provides rules to coordinate the interaction of existing net operating losses, overall domestic losses, and foreign tax credit carry-forward rules with the income inclusions required under section 965.

4. Clarification that qualified deficits are permitted to offset transition earnings

The modification of the Chairman's mark clarifies that the mandatory inclusion required of a U.S. shareholder under the transition rule is generally reduced by the foreign E&P deficits, including qualified deficits.

5. Modification to tax on base erosion payments of taxpayers with substantial gross receipts

The Chairman's modification changes the proposal's tax rate of 10 percent to a rate of 12.5 percent of the modified taxable income of the taxpayer for the taxable year over an amount equal to the regular tax liability (defined in section 26(b)) of the taxpayer for the taxable year for taxable years beginning after December 31, 2025.

That is, under the Chairman's modification the regular tax liability is reduced by an amount equal to all credits allowed under Chapter 1 (including the general business credit), for taxable years beginning after December 31, 2025.

The Chairman's modification excludes an amount paid or incurred for services if those services meet the requirements for the services cost method under section 482 (excluding the requirement that the services not contribute significantly to fundamental risks of business success or failure) and if such amount is the total services cost with no markup, for taxable years beginning after December 31, 2017.

III. NEW PROPOSALS

A. Tax Reforms for Individuals

1. Reduce ACA individual shared responsibility payment to zero

Present Law

Under the Patient Protection and Affordable Care Act[5] (also called the Affordable Care Act, or "ACA"), individuals must be covered by a health plan that provides at least minimum essential coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage (commonly referred to as the "individual mandate").[6] Minimum essential coverage includes government-sponsored programs, eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, and other coverage as recognized by the Secretary of Health and Human Services ("HHS") in coordination with the Secretary of the Treasury.[7] The tax is imposed for any month that an individual does not have minimum essential coverage unless the individual qualifies for an exemption for the month as described below.

The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer's family and (2) 300 percent of the adult individual dollar amount. The individual adult annual dollar amount is $695 for 2018.[8] For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return.[9] The total annual household payment may not exceed the national average annual premium for bronze level health plans for the applicable family size offered through Exchanges that year.

Exemptions from the requirement to maintain minimum essential coverage are provided for the following: (1) an individual for whom coverage is unaffordable because the required contribution exceeds eight percent of household income, (2) an individual with household income below the income tax return filing threshold, (3) a member of an Indian tribe, (4) a

[5] Public Law 111-148.

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

[7] Minimum essential coverage does not include coverage that consists of only certain excepted benefits, such as limited scope dental and vision benefits or long-term care insurance offered under a separate policy, certificate or contract.

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

[9] Sec. 6012(a).

member of certain recognized religious sects or a health sharing ministry, (5) an individual with a coverage gap for a continuous period of less than three months, and (6) an individual who is determined by the Secretary of HHS to have suffered a hardship with respect to the capability to obtain coverage.[10]

Description of Proposal

Under the proposal, the amount of the individual shared responsibility payment enacted as part of the Affordable Care Act is reduced to zero.

Effective Date

The proposal is effective with respect to health coverage status for months beginning after December 31, 2018.

2. Allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver's credit

Present Law

Qualified ABLE programs

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.[11] A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

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

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax

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[10] In addition, certain individuals present or residing outside of the United States and bona fide residents of United States territories are deemed to maintain minimum essential coverage.

[11] Sec. 529A.

exemption). For 2017, this is $14,000.[12] Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (i.e., income on accounts under the program is not subject to current income tax).

A qualified ABLE program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLE program may not allow any interest in the program (or any portion thereof) to be used as security for a loan.

Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account.[13] Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary[14] or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts,[15] no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion ($14,000 for 2017) and, to the extent of such exclusion, are exempt from the

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

[13] The rules of section 72 apply in determining the portion of a distribution that consists of earnings.

[14] For instance, if a designated beneficiary were to relocate to a different State.

[15] In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

generation skipping transfer ("GST") tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

Eligible individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI benefits[16] based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.[17]

Qualified disability expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary's ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for

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[16] These are benefits, respectively, under Title II or Title XVI of the Social Security Act.

[17] No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.

payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State's Medicaid Buy-In program.

Treatment of ABLE accounts under Federal programs

Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any Federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an ABLE account in excess of $100,000. In the case that an individual's ABLE account balance exceeds $100,000, such individual's SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual's resources fall below $100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

Saver's credit

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[18] The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2017, married taxpayers filing joint returns with AGI of $61,500 or less, taxpayers filing head of household returns with AGI of $46,125 or less, and all other taxpayers filing returns with AGI of $30,750 or less are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2016 are provided in the table below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

Credit Rates for Saver's Credit

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

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

[18] Sec. 25B.

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

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer files a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year for which the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

Description of Proposal

The proposal increases the contribution limitation to ABLE accounts under certain circumstances. While the general overall limitation on contributions (the per-donee annual gift tax exclusion ($14,000 for 2017)) remains the same, the limitation is increased with respect to contributions made by the designated beneficiary of the ABLE account. Under the proposal, after the overall limitation on contributions is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the taxable year.

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

The proposal sunsets after December 31, 2025.

Effective Date

The proposal applies to taxable years beginning after the date of enactment.

3. Rollovers between qualified tuition programs and qualified ABLE programs

Present Law

Qualified ABLE programs

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.[19] A qualified ABLE program is a program

[19] Sec. 529A.

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

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

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax exemption). For 2017, this is $14,000.[20] Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (i.e., income on accounts under the program is not subject to current income tax).

A qualified ABLE program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLE program may not allow any interest in the program (or any portion thereof) to be used as security for a loan.

Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account.[21] Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without

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

[21] The rules of section 72 apply in determining the portion of a distribution that consists of earnings.

income tax liability to another ABLE account for the same beneficiary[22] or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts,[23] no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion ($14,000 for 2017) and, to the extent of such exclusion, are exempt from the generation skipping transfer ("GST") tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

Eligible individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI benefits[24] based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.[25]

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[22] For instance, if a designated beneficiary were to relocate to a different State.

[23] In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

[24] These are benefits, respectively, under Title II or Title XVI of the Social Security Act.

[25] No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.

Qualified disability expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary's ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State's Medicaid Buy-In program.

Treatment of ABLE accounts under Federal programs

Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any Federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an ABLE account in excess of $100,000. In the case that an individual's ABLE account balance exceeds $100,000, such individual's SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual's resources fall below $100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

Section 529 qualified tuition programs

In general

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[26] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner")[27] whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

Qualified higher education expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

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

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

Contributions to qualified tuition programs

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

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

Description of Proposal

The proposal allows for amounts from qualified tuition programs (also known as 529 accounts) to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family.[28] Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year.[29] Any amount rolled over that is in excess of this limitation shall be includible in the gross income of the distributee in a manner provided by section 72.[30]

The proposal sunsets after December 31, 2025.

Effective Date

The proposal applies to distributions after December 31, 2017.

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

[29] 529A(b)(2)(B).

[30] 529(c)(3)(A).

4. Extend time limit for contesting IRS levy

Present Law

The IRS is authorized to return property that has been wrongfully levied upon.[31] In general, monetary proceeds from the sale of levied property may be returned within nine months of the date of the levy.

Generally, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in levied property and that such property was wrongfully levied upon may bring a civil action for wrongful levy in a district court of the United States.[32] Generally, an action for wrongful levy must be brought within nine months from the date of levy.[33]

Description of Proposal

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

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

Effective Date

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

5. Individuals held harmless on improper levy on retirement plans

Present Law

Tax-favored retirement savings

Under the Code, tax-favored treatment applies to traditional and Roth individual retirement arrangements ("IRAs") and certain employer-sponsored retirement plans ("employer-sponsored plans").[34] The rules for tax-favored treatment include annual limits on the amount that may be contributed to an IRA or employer-sponsored plan.

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[31] Sec. 6343.

[32] Sec. 7426.

[33] Sec. 6532.

[34] Secs. 219, 408, and 408A provide rules for IRAs. Tax-favored employer-sponsored retirement plans consist of qualified retirement plans under sections 401(a) and 403(a), tax-deferred annuity plans under

In general, a distribution from a traditional IRA or employer-sponsored plan (other than from a designated Roth account under an employer-sponsored plan) is includible in income, except to the extent attributable to any contributions that were made to the IRA or plan on an after-tax basis.[35] Contributions made to a Roth IRA or a designated Roth account are made on an after-tax basis.[36] Certain distributions from a Roth IRA or a designated Roth account are excluded from income; otherwise, a distribution is includible in income, except to the extent attributable to contributions.[37] Amounts that are withdrawn from an IRA or employer-sponsored plan before age 59½ and are includible in income are subject to a 10-percent early withdrawal tax unless an exception applies.[38]

A distribution from a traditional IRA or employer-sponsored plan (other than from a designated Roth account) generally may be rolled over to another traditional IRA or employer-sponsored plan (other than to a designated Roth account).[39] The rollover generally can be achieved by a direct payment from the distributing IRA or plan to the recipient IRA or plan ("direct rollover") or by contributing the distribution to the recipient IRA or plan within 60 days of receiving the distribution ("60-day rollover"). Amounts that are rolled over generally are not includible in gross income. A distribution from a Roth IRA generally may be rolled over to another Roth IRA by direct rollover or a 60-day rollover, and a distribution from a designated Roth account generally may be rolled over to a Roth IRA or another designated Roth account by direct rollover or a 60-day rollover. In general, an individual is permitted to make only one 60-day rollover from an IRA to another IRA within a one-year period.

In addition to these rollovers, an individual generally may convert an amount in a traditional IRA or a non-Roth account under an employer-sponsored defined contribution plan into a Roth IRA or a designated Roth account, referred to as a "Roth conversion." The amount converted is generally includible in the individual's income to the same extent as if a distribution had been made. The conversion may be accomplished by a direct transfer of the amount from the traditional IRA or non-Roth account to the Roth IRA or designated Roth account or by a distribution from the traditional IRA or non-Roth account and contribution to the Roth IRA or designated Roth account within 60 days.

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section 403(b), and State and local government eligible deferred compensation plans under section 457(b). Under section 7701(j), the Thrift Savings Fund is treated as a qualified retirement plan.

[35] Secs. 408(d) and 402.

[36] Secs. 408A(c) and 402A(a)(2).

[37] Secs. 408A(d) and 402A(d).

[38] Sec. 72(t).

[39] A rollover is not permitted with respect to an IRA that an individual has inherited from another individual ("inherited IRA"). In addition, the beneficiary of a deceased employee under an employer-sponsored plan, other than a surviving spouse, may roll a distribution from the plan only to an IRA that is designated as an inherited IRA.

An amount withdrawn from an IRA or employer-sponsored plan made on account of an IRS levy is includible in income in the same manner as other distributions. However, the 10-percent early withdrawal tax does not apply.[40]

Incorrect levies on IRAs and employer-sponsored plans

Present law provides rules under which the IRS returns amounts subject to an incorrect levy.[41] For example, amounts withdrawn from an IRA pursuant to a levy are returned to the individual owning the IRA in the case of a wrongful levy or if the levy was not in accordance with IRS administrative procedures.[42] In the case of a wrongful levy, the IRS is required to pay interest on the amount returned to the individual at the overpayment rate.[43] The IRS is not required to pay interest if the levy was not in accordance with IRS administrative procedures.[44]

Present law does not provide special rules to allow an individual to recontribute to an IRA or employer-sponsored plan an amount withdrawn pursuant to a levy and later returned to the individual by the IRS, or interest thereon. Thus, if an individual wishes to contribute such returned amounts to an IRA or employer-sponsored plan, the contribution is subject to the normally applicable rules, including limits on contributions and the time for making a rollover.

Description of Proposal

Under the proposal, if an amount withdrawn from an IRA ("original IRA") or employer-sponsored plan pursuant to a levy is returned to an individual by the IRS, the individual may contribute the amount returned, and any interest thereon, either to the original IRA or to the employer-sponsored plan, if permissible,[45] or to a different IRA to which a rollover from the original IRA or employer-sponsored plan would be permitted.[46] The contribution is allowed without regard to the normally applicable limits on IRA contributions and rollovers. The proposal applies to a levied amount that is returned to the individual because the levy on the original IRA or employer-sponsored plan (1) was wrongful, or (2) is determined to be premature or otherwise not in accordance with administrative procedures.

[40] Sec. 72(t)(2)(vii).

[41] Sec. 6343(b)-(d).

[42] Secs. 6343(b)(2), 6343(d)(2)(A).

[43] Sec. 6343(c)(1).

[44] Sec. 6343(d)(2).

[45] The terms of an employer-sponsored plan might not permit the amount returned by the IRS to be contributed to the plan. In addition, in the case of an amount withdrawn from a designated Roth account pursuant to the levy, the returned amount could be contributed only to the original designated Roth account (or to a Roth IRA).

[46] The proposal allows a rollover with respect to an inherited IRA to an inherited IRA of the same type (traditional or Roth) as the original IRA.

A contribution under the proposal must be made by the due date (not including extensions) for the individual's income tax return for the year in which the IRS returns the amount previously levied on. A contribution under the proposal is treated as a rollover ("rollover contribution") made for the taxable year in which the distribution on account of the levy occurred, but is not taken into account for purposes of the limit on one IRA rollover within a one-year period. In addition, except in the case of a rollover contribution that is treated as a Roth conversion, any tax attributable to the amount distributed from the original IRA or employer-sponsored plan by reason of a levy (1) is not to be assessed, (2) if assessed, is to be abated, and (3) if collected, is to be credited or refunded as an overpayment made on the due date for the return for the taxable year in which the amount was levied on.

Under the proposal, the IRS is required to pay interest on an amount returned to the individual at the overpayment rate in the case of a levy that is determined to be premature or otherwise not in accordance with administrative procedures (as well as in the case of a wrongful levy under present law). Interest paid by the IRS on the amount returned to the individual and contributed to an IRA or employer-sponsored plan is treated as earnings within the IRA or employer-sponsored plan after the rollover contribution was made and is not includible in gross income when received from the IRS.

When the IRS returns to an individual an amount that was levied on, the IRS must notify the individual that a contribution to the original IRA, the employer-sponsored plan, or a new IRA may be made of the amount returned, and the interest paid, by the due date (not including extensions) for the individual's income tax return for the year in which the amount is returned.

Effective Date

The proposal is effective for levied amounts, and interest thereon, returned to individuals after December 31, 2017.

6. Treatment of certain individuals performing services in the Sinai Peninsula of Egypt

Present Law

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

1. An exclusion from gross income of certain military pay received for any month during which the member served in a combat zone or was hospitalize as a result of serving in a combat zone;[47]

[47] Sec. 112; see also, sec. 3401(a)(1), exempting such income from wage withholding.

2. An exemption from taxes on death while serving in combat zone or dying as a result of wounds, disease, or injury incurred while so serving;[48]

3. Special estate tax rules where death occurs in a combat zone;[49]

4. Special benefits to surviving spouses in the event of a service member's death or missing status;[50]

5. An extension of time limits governing the filing of returns and other rules regarding timely compliance with Federal income tax rules;[51] and

6. An exclusion from telephone excise taxes.[52]

Description of Proposal

The proposal grants combat zone tax benefits to the Sinai Peninsula of Egypt, if as of the date of enactment of the proposal any member of the Armed Forces of the United States is entitled to special pay under section 310 of title 37, United States Code (relating to special pay; duty subject to hostile fire or imminent danger), for services performed in such location. This benefit lasts only during the period such entitlement is in effect.

Effective Date

The proposal is generally effective beginning June 9, 2015. The portion of the proposal related to wage withholding applies to remuneration paid after the date of enactment.

7. Modifications to user fees requirements for installment agreements

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer agrees to pay taxes owed, as well as interest and penalties, in installments over an agreed schedule, if the IRS determines that doing so will facilitate collection of the amounts owed. This agreement provides for a period during which payments may be made and while other IRS enforcement actions are held in abeyance.[53] An installment agreement generally does not reduce the amount of taxes, interest, or penalties owed. However, the IRS is authorized

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[48] Sec. 692.

[49] Sec. 2201.

[50] Secs. 2(a)(3) and 6013(f)(1).

[51] Sec. 7508.

[52] Sec. 4253(d).

[53] Sec. 6331(k).

to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The IRS is required to review such partial payment installment agreements at least every two years to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

Taxpayers can request an installment agreement by filing Form 9465, Installment Agreement Request.[54] If the request for an installment agreement is approved by the IRS, the IRS charges a user fee.[55] Under sections 300.1 and 300.2 of the Treasury Regulations, the IRS currently charges $120 for entering into an installment agreement. If the application is for a direct debit installment agreement, whereby the taxpayer authorizes the IRS to request the monthly electronic transfer of funds from the taxpayer's bank account to the IRS, the fee is reduced to $52. In addition, regardless of the method of payment, the fee is $43 for low-income taxpayers. For this purpose, low-income is defined as a person who falls below 250 percent of the Federal poverty guidelines published annually. Finally, there is no user fee if the agreement qualifies for a short term agreement (l20 days or less).

Description of Proposal

The proposal generally prohibits increases in the amount of user fees charged by the IRS for installment agreements. For low-income taxpayers (those whose income falls below 250 percent of the Federal poverty guidelines), it alleviates the user fee requirement in two ways. First, it waives the user fee if the low-income taxpayer enters into an installment agreement under which the taxpayer agrees to make automated installment payments through a debit account. Second, it provides that low-income taxpayers who are unable to agree to make payments electronically remain subject to the required user fee, but the fee is reimbursed upon completion of the installment agreement.

Effective Date

The proposal applies to agreements entered into on or after the date that is 60 days after the date of enactment.

[54] The IRS accepts applications for installment agreements online, from individuals and businesses, if the total tax, penalties and interest is below $50,000 for the former, and $25,000 for the latter.

[55] 31 U.S.C. sec. 9701; Treas. reg. sec. 300.1. The Independent Offices Appropriations Act of 1952 (IOAA), 65 Stat. B70, (June 27, 1951). A discussion of the IRS practice regarding user fees and a list of actions for which fees are charged is included in the Internal Revenue Manual. See "User Fees," paragraph 1.32.19 IRM, available at https://www.irs.gov/irm/part1/irm_01-032-019.html.

8. Exclusion from gross income of certain amounts received by wrongly incarcerated individuals

Present Law

Under a provision added in the PATH Act,[56] with respect to any wrongfully incarcerated individual, gross income does not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.[57]

A wrongfully incarcerated individual means an individual:

(1) who was convicted of a covered offense;

(2) who served all or part of a sentence of imprisonment relating to that covered offense; and

(3) (i) was pardoned, granted clemency, or granted amnesty for such offense because the individual was innocent, or

(ii) for whom the judgment of conviction for the offense was reversed or vacated, and whom the indictment, information, or other accusatory instrument for that covered offense was dismissed or who was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated.

For these purposes, a covered offense is any criminal offense under Federal or State law, and includes any criminal offense arising from the same course of conduct as that criminal offense.

The Code contains a special rule allowing individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if such claim would be disallowed under the Code or by operation of any law or rule of law (including *res judicata*), if the claim for credit or refund is filed before the close of the one-year period beginning on the date of enactment of the PATH Act (December 18, 2015).[58]

Description of Proposal

The proposal would extend the waiver on the statute of limitations with respect to filing a claim for a credit or refund of an overpayment of tax resulting from the exclusion described

[56] Pub. L. No. 114-113 (2015), Division Q (Protecting Americans from Tax Hikes Act of 2015), sec. 304.

[57] Sec. 139F.

[58] Sec. 139F.

above for an additional year. Thus, under the proposal, such claim for credit or refund must be filed before December 18, 2017.

Effective Date

The provision is effective on the date of enactment.

9. Treatment of student loans discharged on account of death or disability

Present Law

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[59]

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

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

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program, certain State loan repayment programs, or any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State).

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[59] Sec. 108(f).

Description of Proposal

The proposal modifies the exclusion of student loan discharges from gross income, by including within the exclusion certain discharges on account of death or total and permanent disability of the student.[60] Loans eligible for the exclusion under the proposal are loans made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation, or (5) private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Protection Act).[61]

Effective Date

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

10. Modification of the deduction for certain educator expenses

Present Law

In general, business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.[62] However, in the case of certain employees and certain expenses, a deduction may be taken in determining adjusted gross income (referred to as an "above-the-line" deduction), including certain expenses of eligible educators.[63] Eligible educators are elementary or secondary school teachers, instructors, counselors, principals, or aides in a school for at least 900 hours during a school year.[64]

An eligible educator may take an "above-the-line" deduction for ordinary and necessary expenses incurred 1) by reason of participation in professional development courses related to the curriculum or students the educator teaches, or 2) in connection with books, supplies, computer and other equipment, and supplementary materials to be used in the classroom. The deduction may not exceed $250 (for 2017) in expenses, indexed for inflation.

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[60] Although the proposal makes specific reference to those provisions of the Higher Education Act of 1965 that discharge William D. Ford Federal Direct Loan Program loans, Federal Family Education Loan Program loans, and Federal Perkins Loan Program loans in the case of death and total and permanent disability, the proposal also contains a provision providing generally for an exclusion in the case of a student loan discharged on account of the death or total and permanent disability of the student, in addition to those specific statutory references.

[61] 15 U.S.C. 1650(7).

[62] Secs. 62(a)(1), 67, and 162.

[63] Sec. 62(a)(2)(D).

[64] Sec. 62(d)(1).

Description of Proposal

The proposal increases the limit for the deduction of certain expenses of eligible educators to $500.

Effective Date

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

11. Uniform treatment of expenses in contingency fee cases

Present Law

The Code provides that a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.[65]

A current deduction for an expense for which there is a right or expectation of reimbursement may be disallowed because these payments are not expenses of the taxpayer and are instead in the nature of an advance or a loan. The extent to which the right must be established has varied. Some cases have denied the current deduction because the right of reimbursement was fixed,[66] others have allowed the current deduction because the right of reimbursement was uncertain,[67] and other cases have denied the current deduction if the taxpayer's right to reimbursement was subject to a contingency.

Courts have held that an attorney representing clients on a contingent fee basis may not currently deduct advances to or expenses paid on behalf of the clients as ordinary and necessary business expenses.[68] The amounts in these cases were to be repaid from any recovery. Courts have also held that even if reimbursement is due only under certain circumstances, generally no immediate deduction is allowable.[69]

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[65] Sec. 162(a); Treas. Reg. sec. 1.162-1(a).

[66] *Charles Baloian Company, Inc. v. Commissioner*, 68 T.C. 620, 626, 628 (1977); *Manocchio v. Commissioner*, 710 F.2d 1400, 1402 (9th Cir. 1983); *Glendinning, McLeish & Co. v. Commissioner*, 61 F.2d 950, 952 (2d Cir. 1932); *Webbe v. Commissioner*, T.C. Memo. 1987-426, aff'd, 902 F.2d 688 (8th Cir. 1990).

[67] *George K. Herman Chevrolet, Inc. v. Commissioner*, 39 T.C. 846, 853 (1963); *Allegheny Corporation v. Commissioner*, 28 T.C. 298, 305 (1957), acq., 1957-2 C.B. 3; *Electric Tachometer Corporation v. Commissioner*, 37 T.C. 158, 161-162 (1961), acq., 1962-2 C.B. 4.

[68] *Burnett v. Commissioner*, 356 F.2d 755, 760 (5th Cir.), cert. denied, 385 U.S. 832 (1966); *Herrick v. Commissioner*, 63 T.C. 562, 567, 568 (1975); *Canelo v. Commissioner*, 53 T.C. 217, 225 (1969), aff'd, 447 F.2d 484 (9th Cir. 1971), acq. 1971-2 C.B. 2, nonacq. in part, 1982-2 C.B. 2; *Silverton v. Commissioner*, T.C. Memo. 1977-198, aff'd, 647 F.2d 172 (9th Cir.), cert. denied, 454 U.S. 1033 (1981); *Watts v. Commissioner*, T.C. Memo. 1968-183.

[69] *Boccardo v. Commissioner*, 12 Cl Ct. 184 (1987); *Boccardo v. Commissioner*, 65 T.C.M. 2739 (1993).

However, the Ninth Circuit reached the opposite conclusion and held that attorneys who represent clients in "gross fee" contingency fee cases are not extending loans to clients and therefore may treat litigation costs, such as court fees and witness expenses, as deductible business expenses under the Code.[70] The IRS does not follow this decision, except in the Ninth Circuit, based on the fact that amounts advanced by attorneys will be reimbursed by the client and therefore are not deductible business expenses.[71]

Description of Proposal

The proposal denies attorneys an otherwise-allowable deduction for litigation costs paid under arrangements that are primarily on a contingent fee basis until the contingency ends. The proposal effects a legislative override of the opinion in the Ninth Circuit Court of Appeals in *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995). No inference regarding the tax treatment of these costs under present law is intended.

Effective Date

The proposal applies to expenses and costs paid or incurred in taxable years beginning after the date of enactment.

12. Simplified filing requirements for individuals over 65 years of age

Present Law

Persons required to make returns of income are generally required to file returns in the form prescribed by the Secretary in regulations.[72] Income tax returns are required from each individual whose taxable year gross income equals or exceeds the exemption amount, with certain exceptions.[73] The income tax returns are due on April 15 of the year following the taxable year, for taxpayers using a calendar year.

The standard form available for individuals subject to income tax are in the series of form known as Form 1040, and include two simplified versions, the Form 1040A and the Form 1040EZ. In recent filing seasons, the majority of returns filed by individuals were filed electronically.[74]

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[70] *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), rev'g 65 T.C.M. 2739 (1993).

[71] 1997 FSA LEXIS 442 (June 2, 1997).

[72] Sec. 6011.

[73] See section 6012(a)(1)(A), which enumerates several conditions under which individuals with gross income in excess of the exemption amount in section 151(d) are nevertheless excused from the filing requirements.

[74] The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998") states a Congressional policy to promote the paperless filing of Federal tax returns, and set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. See sec. 2001(a) of RRA 1998. The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in

Description of Proposal

The proposal requires that the IRS publish a simplified income tax return form designated a Form 1040SR, for use by persons who are age 65 or older by the close of the taxable year. The form is to be as similar as possible to the Form 1040EZ. The use of Form 1040SR is not to be restricted based on the amount of taxable income to be shown on the return, or the fact that the income to be reported for the taxable year includes social security benefits, distributions from qualified retirement plans, annuities or other such deferred payment arrangements, interest and dividends, or capital gains and losses taken into account in determining adjusted net capital gain.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2018.

13. Sense of the Senate to improve customer service and protections for taxpayers by reinstating appropriate IRS funding levels

The proposal expresses the sense of the Senate that politically motivated budget cuts are counterproductive to deficit reduction, diminish the IRS's ability to adequately serve taxpayers and protect taxpayer information, and reduce the IRS's ability to enforce the law.

14. Return preparation programs for low-income taxpayers

Present Law

The Code provides that the Secretary may allocate up to $6 million per year for matching grants to certain qualified low-income taxpayer clinics.[75] Eligible clinics are those that charge no more than a nominal fee to either represent low-income taxpayers in controversies with the IRS or provide tax information to individuals for whom English is a second language. No clinic can receive more than $100,000 per year.

A qualified low-income taxpayer clinic includes (1) a clinical program at an accredited law, business, or accounting school, in which students represent low-income taxpayers, or (2) an organization exempt from tax under Code section 501(c) which either represents low-income taxpayers or provides referral to qualified representatives. A clinic is treated as representing low-income taxpayers if (i) at least 90 percent of the taxpayers represented by the clinic have income which does not exceed 250 percent of the poverty level, as determined in accordance

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reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, p. 6.

[75] Sec. 7526.

with criteria established by the Director of the Office of Management and Budget, and (ii) the amount in controversy for any taxable year is generally $50,000 or less.[76]

There is no provision in the Code allowing for the allocation of funds for matching grants for return preparation for low-income taxpayers.

In the Consolidated Appropriations Act, 2017,[77] Congress appropriated approximately $2.157 billion to the IRS for taxpayer services, of which not less than $15 million is to be made available for a Community Volunteer Income Tax Assistance ("VITA") matching grants program for tax return preparation assistance. VITA is a program created by the IRS in 1969 which utilizes volunteers to provide tax return preparation and filing service assistance to certain low-income taxpayers and members of underserved populations.

Description of Proposal

The provision codifies the VITA program and provides that the Secretary, unless otherwise provided by specific appropriation, may allocate from otherwise appropriated funds up to $30 million per year in matching grants to qualified entities for the development, expansion, or continuation of qualified tax return preparation programs assisting low-income taxpayers and members of underserved populations. The Secretary is authorized to award a multi-year grant not to exceed three years.

The grant funds may be used for ordinary and necessary operation costs (including for wages or salaries of persons coordinating the activities of the program, to develop training materials, conduct training, and perform quality reviews of the returns for which assistance has been provided under the program, and for equipment purchases and vehicle-related expenses associates with remote or rural tax preparation services), outreach and educational activities relating to the eligibility and availability of income supports available through the Code, and services related to financial education and capability, asset development, and the establishment of savings accounts in connection with tax return preparation, but not for overhead expenses that are not directly related to any qualified return preparation program. In awarding grants, priority is given to applications that (i) demonstrate assistance to certain low-income taxpayers with an emphasis on outreach; (ii) demonstrate taxpayer outreach and education around available income supports available through the Code; and (iii) demonstrate specific outreach and focus on one or more underserved populations. The provision allows the IRS to use mass communications, referrals, and other means to promote the benefits and encourage the use of the program. The Secretary can refer taxpayers to qualified return preparation programs receiving grants and those programs are encouraged to refer eligible individuals to local or regional low income taxpayer clinics.

Qualified return preparation program means any program which provides assistance to individuals, at least 90 percent of whom are low-income taxpayers, in preparing and filing Federal income tax returns, which is administered by a qualified entity, in which all volunteers

[76] Sec. 7463.

[77] Pub. L. No. 115-31, Div. E, Title I (May 5, 2017).

who assist in the preparation of Federal income tax returns meet the training requirements prescribed by the Secretary, and which uses a quality review process which reviews 100 percent of all returns. Qualified entity means any entity which is an eligible organization (as defined), is in compliance with Federal tax filing and payment requirements, is not debarred or suspended from Federal contracts, grants, or cooperative agreements, and agrees to provide documentation to substantiate any matching funds provided under the VITA grant program. Eligible organization means an institution of higher education described in section 102 (other than subsection (a)(1)(C) thereof) of the Higher Education Act of 1965, as in effect on the date of enactment, and which has not been disqualified from participating in a program under Title IV of such Act, an exempt organization described in Code section 501(c), a local government agency, including a county or municipal government agency, and an Indian tribe, as defined in section 4(12) of the Native American Housing Assistance and Self-Determination Act of 1996 ("Act"), including any tribally designated housing entity (as defined in such Act), tribal subsidiary, subdivision, or other wholly owned tribal entity, or a local, State, regional, or national coalition (with one lead organization which meets the eligibility requirements described above acting as the applicant organization. If no eligible organization is available to assist the targeted population or community, the eligible organization includes a State government agency, and a Cooperative Extension Service office. Low-income taxpayer means a taxpayer who has income for the taxable year which does not exceed an amount equal to the completed phaseout amount under section 32(b) for a married couple filing a joint return with three or more qualifying children, as determined in a revenue procedure or other published guidance. Underserved population includes populations of persons with disabilities, persons with limited English proficiency, Native Americans, individuals living in rural areas, members of the Armed Forces and their spouses, and the elderly.

Effective Date

The proposal is effective on the date of enactment.

15. Qualified tuition programs (529 accounts) may be established for the *in utero*

Present Law

In general

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[78] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is

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

established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner")[79] whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

Qualified higher education expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

Contributions to qualified tuition programs

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

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

Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

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

Description of Proposal

The proposal specifies that nothing in Code section 529 shall prevent an unborn child from qualifying as a designated beneficiary. For these purposes, an unborn child means a child in utero, and the term child *in utero* means a member of the species *homo sapiens*, at any stage of development, who is carried in the womb.

The proposal sunsets after December 31, 2025.

Effective Date

The proposal applies to contributions made after December 31, 2017.

16. Relief for retirement plan distributions and modification of casualty loss deduction for the Mississippi River Delta flood disaster area

Present Law

Distributions from tax-favored retirement plans

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (a "section 403(b) plan"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457(b) plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed.[80] These plans are referred to collectively as "eligible retirement plans." In addition, unless an exception applies, a distribution from a qualified retirement plan, a section 403(b) plan, or an IRA received before age 59½ is subject to a 10-percent additional tax (referred to as the "early withdrawal tax") on the amount includible in income.[81]

In general, a distribution from an eligible retirement plan may be rolled over to another eligible retirement plan within 60 days, in which case the amount rolled over generally is not

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

[81] Sec. 72(t). Under present law, the 10-percent early withdrawal tax does not apply to distributions from a governmental section 457(b) plan.

includible in income. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.

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

Itemized deduction for casualty losses

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[82] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income

Description of Proposal

In general

The proposal provides tax relief, as described below, relating to the "Mississippi River Delta flood disaster area," defined as the area with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act before September 3, 2016, by reason of severe storms and flooding occurring in Louisiana during August of 2016.

Distributions from eligible retirement plans

The proposal provides an exception to the 10-percent early withdrawal tax in the case of a qualified Mississippi River Delta flooding distribution from a qualified retirement plan, a section 403(b) plan or an IRA. In addition, as discussed further, income attributable to a qualified Mississippi River Delta flooding distribution may be included in income ratably over three years, and the amount of a qualified Mississippi River Delta flooding distribution may be recontributed to an eligible retirement plan within three years.

A qualified Mississippi River Delta flooding distribution is a distribution from an eligible retirement plan made on or after August 11, 2016, and before January 1, 2018, to an individual whose principal place of abode on August 11, 2016, was located in the Mississippi River Delta disaster area and who has sustained an economic loss by reason of the severe storms and flooding giving rise to the Presidential disaster declaration. The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified Mississippi River

[82] Sec. 165.

Delta flooding distributions is $100,000. Thus, any distributions in excess of $100,000 during the applicable period are not qualified Mississippi River Delta flooding distributions.

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

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

A qualified Mississippi River Delta flooding distribution is a permissible distribution from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan, regardless of whether a distribution otherwise would be permissible.[83] A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified Mississippi River Delta flooding distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer's controlled group or affiliated service group does not exceed $100,000. Thus, a plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of $100,000, taking into account distributions from plans of other employers or IRAs.

Modification of rules related to casualty losses

Under the proposal, in the case of a personal casualty loss which arose in the Mississippi River Delta flood disaster area on or after August 11, 2016, where such loss was attributable to the severe storms and flooding giving rise to the Presidential declaration, such losses are deductible without regard to whether aggregate net losses exceed ten percent of a taxpayer's adjusted gross income, although in order to be deductible the losses must exceed $500 per casualty. Additionally, such losses may be claimed in addition to the standard deduction.

Effective Date

The proposal is effective on the date of enactment.

[83] A qualified Mississippi River Delta flooding distributions is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.

B. Business Tax Reform

1. Amortization of research and experimental expenditures

Present Law

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[84] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[85] Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[86] Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years.[87] Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a)[88] or section 263A.[89]

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[90] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[91] Uncertainty exists when information available to the taxpayer is

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[84] Secs. 167 and 263(a).

[85] Secs. 174(a) and (e).

[86] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize its section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

[87] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime.

[88] Sec. 263(a)(1)(B).

[89] Sec. 263A(c)(2).

[90] Treas. Reg. sec. 1.174-2(a)(1) and (2). Product is defined to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. Treas. Reg. sec. 1.174-2(a)(11), Example 10, provides an example of new process development costs eligible for section 174 treatment.

[91] Treas. Reg. sec. 1.174-2(a)(1).

not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[92] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[93] In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.[94]

Research or experimental expenditures under section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with literary, historical, or similar projects.[95] For purposes of section 174, quality control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.[96]

Generally, no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[97] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[98]

Description of Proposal

Under the proposal, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were

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[92] *Ibid.*

[93] See Treas. Reg. sec. 1.174-4(c). The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent. Treas. Reg. sec. 1.174-2(a)(1).

[94] Rev. Proc. 2000-50, 2000-2 C.B. 601.

[95] Treas. Reg. sec. 1.174-2(a)(6).

[96] Treas. Reg. sec. 1.174-2(a)(7).

[97] Sec. 174(c).

[98] Sec. 174(d). Special rules apply with respect to geological and geophysical costs (section 167(h)), qualified tertiary injectant expenses (section 193), intangible drilling costs (sections 263(c) and 291(b)), and mining exploration and development costs (sections 616 and 617).

paid or incurred. Specified research or experimental expenditures which are attributable to research that is conducted outside of the United States[99] are required to be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

Specified research or experimental expenditures do not include expenditures for land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule is treated as a change in the taxpayer's method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. This rule is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2025 (hence there is no adjustment under section 481(a) for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2026).

Effective Date

The proposal applies to amounts paid or incurred in taxable years beginning after December 31, 2025.

2. Employer credit for paid family and medical leave

Present Law

Present law does not provide a credit to employers for compensation paid to employees while on leave.

Description of Proposal

This proposal would allow eligible employers to claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave ("FMLA") if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent.

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[99] For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

An eligible employer is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and who allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis. For purposes of this requirement, leave paid for by a State or local government is not taken into account. A "qualifying employee" means any employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.[100]

"Family and medical leave" is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993.[101] If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave would not be considered to be family and medical leave.

This proposal would not apply to wages paid in taxable years beginning after December 31, 2019.

The Government Accountability Office (GAO) would complete a study that examines the effectiveness of the tax credit for access to and promotion of paid family and medical leave policies, provide recommendations for ways to modify or enhance the tax credit to further promote access to paid family and medical leave, and provide suggestions of alternative policies that Federal and State governments could implement.

Effective Date

The proposal is generally effective for wages paid in taxable years beginning after December 31, 2017. The GAO study will be completed not later than four years after the date of enactment.

3. Modify tax treatment of Alaska Native Corporations and settlement trusts

Present Law

The Alaska Native Claims Settlement Act ("ANCSA")[102] established Native Corporations[103] to hold property for Alaska Natives. Alaska Natives are generally the only

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[100] Sec. 414(g)(1)(B) ($120,000 for 2017).

[101] In order to be an eligible employer, an employer must provide certain protections applicable under the Family and Medical Leave Act of 1993, regardless of whether they otherwise apply. Specifically, the employer must provide paid family and medical leave in compliance with a policy which ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.

[102] 43 U.S.C. 1601 *et. seq.*

[103] Defined at 43 U.S.C. 1602(m).

permitted common shareholders of those corporations under section 7(h) of ANCSA, unless a Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits a Native Corporation to transfer money or other property to an Alaska Native Settlement Trust ("Settlement Trust") for the benefit of beneficiaries who constitute all or a class of the shareholders of the Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.[104]

Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by a Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from a Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period. Amounts distributed in excess of the amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Native Corporation. This rule prevents a stockholder from being able to take

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[104] With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

advantage of a decrease in value of a Native Corporation that is caused by a transfer of assets from the Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under Section 6034A.

The election to pay tax at the lowest rate is not available in certain disqualifying cases where transfer restrictions have been modified to allow a transfer of either: (a) a beneficial interest that would not be permitted by section 7(h) of the Alaska Native Claims Settlement Act if the interest were Settlement common stock, or (b) any stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement common stock and the Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying transfers, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.

Description of Proposal

The proposal comprises three separate but related sections. The first section allows a Native Corporation to assign certain payments described in ANCSA to a Settlement Trust without having to recognize gross income from those payments, provided the assignment is in writing and the Native Corporation has not received the payment prior to assignment. The Settlement Trust is required to include the assigned payment in gross income when received.

The second section allows a Native Corporation to elect annually to deduct contributions made to a Settlement Trust. If the contribution is in cash, the deduction is in the amount of cash contributed. If the contribution is property other than cash, the deduction is the amount of the Native Corporation's basis in the contributed property, and no gain or loss can be recognized on the contribution. The Native Corporation's deduction is limited to the amount of its taxable income for that year, and any unused deduction may be carried forward 15 additional years. The Native Corporation's earnings and profits for the taxable year are reduced by the amount of any deduction claimed for that year.

Generally, the Settlement Trust must report income equal to the deduction by the Native Corporation. For contributions of property other than cash, the Settlement Trust takes a basis in the property equal to its basis in the hands of the Native Corporation immediately before the contribution, and may elect to defer recognition of income associated with such property until the Settlement Trust sells or disposes of the property. In that case, any income that is deferred is treated as ordinary income, while any gain in excess of the amount that is deferred takes the same character as if the election had not been made. If property subject to this election is disposed of within the first taxable year subsequent to the taxable year in which the property was contributed to the Settlement Trust, the election is voided with respect to the property, the Settlement Trust is required to file an amended return for the taxable year in which the property was contributed, and the Settlement Trust is required to pay any tax applicable to the disposition of the property, including interest, as well as a penalty of 10 percent of the amount of the tax. The proposal provides for a four year assessment period for which to assess the tax, interest, and penalty amounts. The proposal permits the amendment of the terms of any Settlement Trust agreement to allow this election within one year of the enactment of the proposal, with certain restrictions.

The third section of the proposal requires any Native Corporation which has made an election to deduct contributions to a Settlement Trust as described above to furnish a statement to the Settlement Trust containing: (1) the total amount of contributions; (2) whether such contribution was in cash; (3) for non-cash contributions, the date that such property was acquired by the Native Corporation and the adjusted basis of such property on the contribution date; (4) the date on which each contribution was made to the Settlement Trust; and (5) such information as the Secretary determines is necessary for the accurate reporting of income relating to such contributions.

Effective Date

The proposal relating to the exclusion for ANCSA payments assigned to Settlement Trusts is effective to taxable years beginning after December 31, 2016.

The proposal relating to the deduction of contributions is effective for taxable years for which the Native Corporation's refund statute of limitations period has not expired, and the proposal provides a one-year waiver of the refund statute of limitations period in the event that the period expires before the end of the one-year period beginning on the date of enactment.

The proposal relating to the reporting requirement applies to taxable years beginning after December 31, 2016.

4. Low income housing credit modifications

Present Law

In general

The low-income housing tax credit ("LIHTC") may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[105] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

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[105] Sec. 42.

Qualified low-income housing project

To qualify for the low-income housing tax credit, the incomes of the tenants must satisfy certain targeting rules. A project is a qualified low-income housing project if 20 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified low-income housing project if 40 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). A unit is rent-restricted if the gross rent does not exceed 30 percent of income. The owner must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified low-income housing projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test. For many projects every unit satisfies the income targeting rules such that the applicable fraction is 100 percent, and the eligible basis of the entire project qualifies for the credit.

Qualified allocation plan

Each State must develop a qualified allocation plan for allocating low-income housing credits.[106] First, the qualified allocation plan must set forth selection criteria to be used to determine housing priorities of the housing credit agency that are appropriate to local conditions.[107] The qualified action plan must also give preference in allocating housing credit dollar amounts among selected projects to projects: (1) serving the lowest income tenants, (2) obligated to serve qualified tenants for the longest periods, and (3) located in qualified census tracts and the development of which contributes to a concerted community revitalization plan. Third, the qualified allocation plan must provide a procedure that the agency will follow in monitoring for, and notifying the IRS of, noncompliance with section 42 and in monitoring for noncompliance with habitability standards through regular site visits.

Recapture

Any building must remain in compliance with the 20-50 test or the 40-60 test, as applicable, for the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

If any building subject to the 15-year compliance period fails to remain part of a qualified low-income project the accelerated portion of the credit is recaptured, with interest, for all prior years.

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[106] Sec. 42(m)(1)(B).

[107] The selection criteria set forth in a qualified allocation plan must include: (1) project location; (2) housing needs characteristics; (3) project characteristics, including whether the project includes the use of existing housing as part of a community revitalization plan; (4) sponsor characteristics; (5) tenant populations with special housing needs; (6) public housing waiting lists; (7) tenant populations of individuals with children; (8) projects intended for eventual tenant ownership; (9) the energy efficiency of the project; and (10) the historic nature of the project. Sec. 42(m)(1)(C).

Description of Proposal

The proposal incorporates several provisions of S.548, the Affordable Housing Credit Improvement Act of 2017:

- Section 302. Reconstruction or replacement period after casualty loss: The proposal provides that the determination of recapture will not be made with respect to a property the basis of which is affected by a casualty loss until the period established by the applicable housing agency has expired. The period established by the applicable housing is not to exceed 25 months from the date of the casualty.

- Section 303. Modification of rights relating to building purchase: The proposal replaces the right of first refusal, after the close of the compliance period, held by tenants, resident management corporation, qualified nonprofit organization, or government agency with a purchase option held by the foregoing at the present law minimum purchase price as a feature the mere presence of which will not cause any Federal income tax benefit to be allowable with respect to any qualified low-income housing building.

- Section 307. Determination of community revitalization plan to be made by State housing credit agency: The proposal provides that the criteria established by a housing credit agency for determining whether the development of a project contributes to a concerted community development plan is to take into account any factors the agency deems appropriate, including the extent to which the proposed plan (1) is geographically specific; (2) outlines a clear plan for implementation and goals for outcomes; (3) includes a strategy for applying for or obtaining commitments of public or private investment (or both) in nonhousing infrastructure, amenities, or services; and (4) demonstrates the need for community revitalization.

- Section 308. Prohibition of local approval and contribution requirements: Under the proposal, the selection criteria under a qualified allocation plan shall not include consideration of (1) any support or opposition with respect to the project from local or elected leaders, or (2) any local government contribution to the project, except to the extent such contribution is taken into account as part of a broader consideration of the project's ability to leverage outside funding sources, and is not prioritized over any other source of outside funding.

- Section 401. Selection criteria under qualified allocation plans: The proposal requires that qualified allocation plans include selection criteria that take into consideration of the affordable housing needs of individuals in the State who are members of Indian tribes.

- Section 501. Affordable housing tax credit: The proposal renames the "Low-Income Housing Tax Credit" the "Affordable Housing Tax Credit"

Effective Date

Section 302 applies to casualty losses arising after the date of enactment. Section 303 applies to agreements entered into or amended after the date of enactment. Section 307 applies to allocations apply to allocations of housing credit dollar amounts made under qualified allocation plans adopted after December 31, 2017. Sections 308 and 401 apply to allocations of credits made after December 31, 2017. Section 501 is effective on the date of enactment.

5. Expansion of qualifying beneficiaries of an electing small business trust

Present Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation.[108] Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.[109]

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Description of Proposal

The proposal allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Date

The proposal takes effect on January 1, 2018.

6. Charitable contribution deduction for electing small business trusts

Present Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation.[110] The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax

[108] Sec. 1361(c)(2)(A)(v).

[109] Sec. 1361(b)(1)(C) and (c)(2)(B)(v).

[110] Sec. 1361(c)(2)(A)(v).

imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,[111] rather than the deduction applicable to individuals,[112] applies to the trust. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

Description of Proposal

The proposal provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

Effective Date

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

7. Deductibility of penalties and fines for Federal income tax purposes

Present Law

The Code denies a deduction for fines or penalties paid to a government for the violation of any law.[113]

Description of Proposal

The proposal denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely

[111] Sec. 642(c).

[112] Sec. 170.

[113] Sec. 162(f).

paid. The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

The proposal applies only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law.[114] An exception also applies to any amount paid or incurred as taxes due.

The proposal requires government agencies (or entities treated as such agencies under the proposal) to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

Effective Date

The proposal is effective for amounts paid or incurred after the date of enactment, except that it would not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Such exception does not apply to an order or agreement requiring court approval unless the approval was obtained before such date.

8. Aircraft management services

Present Law

Excise tax on taxable transportation by air

Section 4261 imposes an excise tax on amounts paid for taxable transportation. In general, for domestic flights, the tax consists of two parts: a 7.5 percent ad valorem tax applied to the amount paid and a flat dollar amount for each flight segment (consisting of one takeoff and one landing). "Taxable transportation" generally means transportation by air which begins and ends in the United States. The tax is paid by the person making the payment subject to tax and the tax is collected by the person receiving the payment.

In determining whether a flight constitutes taxable transportation and whether the amounts paid for such transportation are subject to tax, the Internal Revenue Service ("IRS") has

[114] Thus, for example, the provision does not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause the payment to be made "at the direction of a government" for purposes of the provision.

looked at who has "possession, command, and control" of the aircraft based on the relevant facts and circumstances.

Aircraft management services companies

Generally, an aircraft management services company ("management company") has as its business purpose the management of aircraft owned by other corporations or individuals ("aircraft owners"). In this function, management companies provide aircraft owners, among other things, with administrative and support services (such as scheduling, flight planning, and weather forecasting), aircraft maintenance services, the provision of pilots and crew, and compliance with regulatory standards. Although the arrangement between management companies and aircraft owners may vary, it is our understanding that aircraft owners generally pay management companies a monthly fee to cover the fixed expenses of maintaining the aircraft (such as insurance, maintenance, and recordkeeping) and a variable fee to cover the cost of using the aircraft (such as the provision of pilots, crew, and fuel).

Suspension and closing of audits

In March 2012, the Internal Revenue Service issued a Chief Counsel Advice determining that a management company provided all of the essential elements necessary for providing transportation by air and the owner relinquished possession, command and control to the management company. Thus, the management company was determined to be providing taxable transportation to the owner and was required to collect the appropriate federal excise tax from the aircraft owner and remit it to the IRS. The Chief Counsel Advice resulted in increased audit activity by the IRS on aircraft management companies.

In May 2013, the IRS suspended assessment of the federal excise tax with respect to aircraft management services while it developed guidance on the tax treatment of aircraft management issues. In 2017, the IRS decided not to pursue examination of the issue of whether amounts paid to aircraft companies by the owners or lessors of the aircraft are taxable until further guidance is made available. According to the IRS, for any exam in suspense the aircraft management fee issue was conceded and the taxpayers were notified accordingly.[115] The IRS has not issued further guidance on this issue.

Description of Proposal

The proposal exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation by air. Exempt payments are those amounts paid by an aircraft owner for management services related to maintenance and support of the owner's aircraft or flights on the owner's aircraft. Applicable services include support activities related to the aircraft itself, such as its storage, maintenance, and fueling, and those related to its operation, such as the hiring and training of pilots and crew, as well as administrative services such as scheduling, flight planning, weather forecasting, obtaining

[115] See also, Kerry Lynch, *IRS To Shelve Pending Audits on Aircraft Management Fees*, AINonline (July 17, 2017) http://www.ainonline.com/aviation-news/business-aviation/2017-07-17/irs-shelve-pending-audits-aircraft-management-fees.

insurance, and establishing and complying with safety standards. Aircraft management services also include such other services as are necessary to support flights operated by an aircraft owner.

The term "aircraft owner" includes a person who leases the aircraft other than under a disqualified lease. A disqualified lease means a lease from a person providing aircraft management services with respect to such aircraft (or a related person to the person provides such services) if such lease is for a term of 31 days or less. The exclusion applies on a pro rata basis to payments for which only a portion are attributable to aircraft management services.

Effective Date

The proposal is effective for amounts paid after the date of enactment.

9. Create qualified opportunity zones

Present Law

From time to time, the Code has provided several incentives aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries.[116]

One of these incentives is a federal income tax credit that is allowed in the aggregate amount of 39 percent of a taxpayer investment in a qualified community development entity (CDE).[117] In general, the credit is allowed to a taxpayer who makes a "qualified equity investment" in a CDE which further invests in a "qualified active low-income community business." CDEs are required to make investments in low income communities (generally communities with 20 percent or greater poverty rate or median family income less than 80 percent of statewide median). The credit is allowed over seven years, five percent in each of the first three years and six percent in each of the next four years. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed. The Department of Treasury's Community Development Financial Institutions Fund ("CDFI") allocates the new markets tax credits.

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[116] Such designated areas were referred to as empowerment zones, the District of Columbia Enterprise ("DC") Zone, and the Gulf Opportunity ("GO") Zone, and each of these designations and attendant tax incentives have expired. The designations and tax incentives for the DC Zone, and the GO Zone generally expired after December 31, 2011. 1400(f), 1400N(h), 1400N(c)(5), 1400N(a)(2)(D), 1400N(a)(7)(C), 1400N(d). The empowerment zones program and attendant tax incentives expired as of December 31, 2016. Secs. 1391(d)(1), There are also areas that were designated as renewal communities under section 1400E which received tax benefits that all expired as of December 31, 2009, except that a zero-percent capital gains rate applies with respect to gain from the sale through December 31, 2014 of a qualified community asset acquired after December 31, 2001, and before January 1, 2010 and held for more than five years. For more information on these programs and attendant tax incentives, see Joint Committee on Taxation, *Incentives for Distressed Communities: Empowerment Zones and Renewal Communities* (JCX-38-09), October 5, 2009.

[117] Sec. 45D.

The maximum annual amount of qualified equity investments is $3.5 billion for calendar years 2010 through 2019. The new markets tax credit is set to expire on December 31, 2019. No amount of unused allocation limitation may be carried to any calendar year after 2024.

Description of Proposal

The proposal provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in the qualified opportunity fund.

The proposal allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

Governors may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts, otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations. The Secretary must designate zones if a governor fails to submit nominations within a specified period of time.

The proposal provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The proposal intends that the certification process for a qualified opportunity fund will be done by the CDFI in a manner similar to the process for allocating the new markets tax credit. The proposal provides the Secretary authority to carry out the process.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the proposal.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

Effective Date

The proposal is effective on the date of enactment.

10. Expensing of certain costs of replanting citrus plants lost by reason of casualty

Present Law

In general

The uniform capitalization ("UNICAP") rules, which were enacted as part of the Tax Reform Act of 1986,[118] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be either capitalized into the basis of such property or included in inventory, as applicable.[119] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be either capitalized into the basis of such property or included in inventory, as applicable.

[118] Sec. 803(a) of Pub. L. No. 99-514 (1986).

[119] Sec. 263A.

Section 263A generally requires the capitalization of the direct and indirect costs allocable to the production of any property in a farming business, including animals and plants without regard to the length of their preproductive period.[120] The costs of a plant generally required to be capitalized under section 263(a) include preparatory costs incurred so that the plant's growing process may begin, such as the acquisition costs of the seed, seedling, or plant. Under section 263A, the costs of producing a plant generally required to be capitalized also include the preproductive period costs of planting, cultivating, maintaining, and developing the plant during the preproductive period.[121] Preproductive period costs may include management, irrigation, pruning, soil and water conservation, fertilizing, frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes, and interest, as applicable.[122]

<u>Special rules for plant farmers</u>

Section 263A provides an exception to the general capitalization requirements for taxpayers who raise, harvest, or grow trees.[123] Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any plant having a preproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).[124] Hence, in general, the UNICAP rules apply to the production of plants that have a preproductive period of more than two years, and to taxpayers required to use an accrual method of accounting.

Plant farmers otherwise required to capitalize preproductive period costs may elect to deduct such costs currently, provided the alternative depreciation system described in section 168(g)(2) is used on all farm assets and the preproductive period costs are recaptured upon disposition of the product.[125] The election is not available to taxpayers required to use the accrual method of accounting. Moreover, the election is not available with respect to certain costs attributable to planting, cultivating, maintaining, or developing citrus or almond groves.

Section 263A does not apply to costs incurred in replanting edible crops for human consumption following loss or damage due to freezing temperatures, disease, drought, pests, or

[120] Treas. Reg. sec. 1.263A-4(b)(1).

[121] Treas. Reg. sec. 1.263A-4(b)(1)(i).

[122] *Ibid.*

[123] Sec. 263A(c)(5).

[124] Sec. 263A(d).

[125] Sec. 263A(d)(3), (e)(1), and (e)(2).

casualty.[126] The same type of crop as the lost or damaged crop must be replanted. However, the exception to capitalization still applies if the replanting occurs on a parcel of land other than the land on which the damage occurred provided the acreage of the new land does not exceed that of the land to which the damage occurred and the new land is located in the United States. This exception may also apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred at all times during the taxable year in which the replanting costs are paid or incurred, and (2) the person holding a minority equity interest and claiming the deduction materially participates in the planting, maintenance, cultivation, or development of the property during the taxable year in which the replanting costs are paid or incurred.[127]

Description of Proposal

The proposal modifies the special rule for costs incurred by persons other than the taxpayer in connection with replanting an edible crop for human consumption following loss or damage due to casualty. Under the proposal, with respect to replanting costs paid or incurred after the date of enactment, but no later than a date which is ten years after such date of enactment, for citrus plants lost or damaged due to casualty, such costs may also be deducted by a person other than the taxpayer if (1) the taxpayer has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which the replanting costs are paid or incurred and such other person holds any part of the remaining equity interest, or (2) such other person acquires all of the taxpayer's equity interest in the land on which the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

Effective Date

The proposal is effective for costs paid or incurred after the date of enactment.

[126] Sec. 263A(d)(2). Such replanting costs generally include costs attributable to the replanting, cultivating, maintaining, and developing of the plants that were lost or damaged that are incurred during the preproductive period. Treas. Reg. sec. 1.263A-4(e)(1). The acquisition costs of the replacement trees or seedlings must still be capitalized under section 263(a) (see, *e.g.*, T.D. 8897, 65 FR 50638, Treas. Reg. sec. 1.263A-4(e)(3), Examples 1 - 3, and TAM 9547002 (July 18, 1995)), potentially subject to the special bonus depreciation deduction in the year of planting under section 168(k)(5).

[127] Sec. 263A(d)(2)(B). Material participation for this purpose is determined in a similar manner as under section 2032A(e)(6) (relating to qualified use valuation of farm property upon death of the taxpayer).

11. Deny deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment or sexual abuse

Present Law

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[128] However, certain exceptions apply. No deduction is allowed for (1) any charitable contribution or gift that would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

Description of Proposal

Under the proposal, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

Effective Date

The proposal is effective for amounts paid or incurred after date of enactment.

12. Repeal charitable contribution substantiation exception for contributions reported by donee organization

Present Law

Charitable contributions

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

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

[128] Sec. 162(a).

must be made within the taxable year.[129] Fourth, the transfer must be of money or property—contributions of services are not deductible.[130] Finally, the transfer must be substantiated and in the proper form.

Substantiation and other formal requirements

In general

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.[131] In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[132]

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[133]

If the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[134] In general, taxpayers are required to obtain

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

[130] For example, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

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

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

[133] Sec. 6115.

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

a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

Exception for certain contributions reported by the donee organization

Subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. "[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished."[135] No such final regulations have been issued.[136]

Description of Proposal

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

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2016.

13. Provide an exception to the private foundation excess business holdings rules for philanthropic business holdings

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code") is further classified as either a public charity or

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

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

a private foundation. An organization may qualify as a public charity in several ways.[137] Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations (including medical research organizations), certain organizations providing assistance to colleges and universities, and governmental units.[138] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[139] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (*e.g*., fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[140] A supporting organization, *i.e*., an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets certain other requirements of the Code, also is classified as a public charity.[141]

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g*., an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities, as well as a tax on their net investment income.[142]

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

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

[139] Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A-9(f)(3).

[140] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

[141] Sec. 509(a)(3). Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

[142] Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-

Excess business holdings of private foundations

Private foundations are subject to tax on excess business holdings.[143] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (substituting "profits interest" for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[144] This five-year period may be extended an additional five years in limited circumstances.[145] The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.[146]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Description of Proposal

The proposal creates an exception to the excess business holdings rules for certain philanthropic business holdings. Specifically, the tax on excess business holdings does not apply with respect to the holdings of a private foundation in any business enterprise that, for the taxable year, satisfies the following requirements: (1) the ownership requirements; (2) the "all profits to charity" distribution requirement; and (3) the independent operation requirements.

The ownership requirements are satisfied if: (1) all ownership interests in the business enterprise are held by the private foundation at all times during the taxable year; and (2) all the

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dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

[143] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[144] Sec. 4943(c)(6).

[145] Sec. 4943(c)(7).

[146] Sec. 4943(d)(3).

private foundation's ownership interests in the business enterprise were acquired under the terms of a will or trust upon the death of the testator or settlor, as the case may be.

The "all profits to charity" distribution requirement is satisfied if the business enterprise, not later than 120 days after the close of the taxable year, distributes an amount equal to its net operating income for such taxable year to the private foundation. For this purpose, the net operating income of any business enterprise for any taxable year is an amount equal to the gross income of the business enterprise for the taxable year, reduced by the sum of: (1) the deductions allowed by chapter 1 of the Code for the taxable year that are directly connected with the production of the income; (2) the tax imposed by chapter 1 on the business enterprise for the taxable year; and (3) an amount for a reasonable reserve for working capital and other business needs of the business enterprise.

The independent operation requirements are met if, at all times during the taxable year, the following three requirements are satisfied. First, no substantial contributor to the private foundation, or family member of such a contributor, is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of the foregoing). Second, at least a majority of the board of directors of the private foundation are not also directors or officers of the business enterprise or members of the family of a substantial contributor to the private foundation. Third, there is no loan outstanding from the business enterprise to a substantial contributor to the private foundation or a family member of such contributor. For purposes of the independent operation requirements, "substantial contributor" has the meaning given to the term under section 4958(c)(3)(C), and family members are determined under section 4958(f)(4).

The proposal does not apply to the following organizations: (1) donor advised funds or supporting organizations that are subject to the excess business holdings rules by reason of section 4943(e) or (f); (2) any trust described in section 4947(a)(1) (relating to charitable trusts); or (3) any trust described in section 4947(a)(2) (relating to split-interest trusts).

Effective Date

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

14. Repeal of special rule permitting recharacterization of IRA contributions

Present Law

Individual retirement arrangements

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[147] to which both deductible and nondeductible contributions may be

[147] Sec. 408.

made,[148] and Roth IRAs, to which only nondeductible contributions may be made.[149] The principal difference between these two types of IRAs is the timing of income tax inclusion.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2017) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased annually ("indexed") as needed to reflect increases in the cost-of living. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to $1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI") for the taxable year over certain indexed levels.[150] To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible after-tax contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ before to the close of a year is not permitted to make contributions to a traditional IRA for that year.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of the individual's basis.[151] All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-

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[148] Sec. 219.

[149] Sec. 408A.

[150] Sec. 219(g).

[151] Basis results from after-tax contributions to traditional IRAs or a rollovers to traditional IRAs of after-tax amounts from another eligible retirement plan.

taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions.

Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA.[152] The amount converted is includible in the taxpayer's income as if a withdrawal had been made.[153] The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, tax-deferred annuity plans, and governmental eligible deferred compensation plans[154]) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must are contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).[155]

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[152] Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

[153] Subject to various exceptions, distributions from an IRA before age 59½ that are includible in income are subject to a 10-percent early distribution tax under section 72(t). An exception applies to an amount includible in income as a result of the conversion from a traditional IRA into a Roth IRA. However, the early distribution tax applies if the taxpayer withdraws the amount within five years of the conversion.

[154] Secs. 401(a), 403(a), 403(b) and 457(b).

[155] As in the case of a conversion of an amount from a traditional IRA to a Roth IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.

Recharacterization of IRA contributions

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year.[156] In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a pro rata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may establish multiple Roth IRAs, for example, Roth IRAs with different investment strategies, and divide the amount being converted among the IRAs. The individual can then choose whether to recharacterize any of the Roth IRAs as a traditional IRA by transferring the entire amount in the particular Roth IRA to a traditional IRA.[157] For example, if the value of the assets in a particular Roth IRA declines after the conversion, the conversion can be reversed by recharacterizing that IRA as a traditional IRA. The individual may then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. Treasury regulations prevent the reconversion from taking place immediately after the recharcterization, by requiring a minimum period to elapse before the reconversion. Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.[158]

Description of Proposal

The proposal repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Thus, for example, under the proposal, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion).[159]

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[156] Sec. 408A(d)(6).

[157] Treas. Reg. sec. 1.408A-5, Q&A-2(b).

[158] Treas. Reg. sec. 1.408A-5, Q&A-9.

[159] The proposal does not preclude an individual from making a contribution to a traditional IRA and converting the traditional IRA to a Roth IRA. Rather, the proposal would preclude the individual from later unwinding the conversion through a recharacterization.

Effective Date

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

15. Length of service award programs for bona fide public safety volunteers

Present Law

Special rules apply to deferred compensation plans of State and local government and private, tax-exempt employers.[160] However, an exception to these rules applies in the case of a plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by the volunteers. For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a bona fide volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length of service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers. The exception applies only if the aggregate amount of length of service awards accruing for a bona fide volunteer with respect to any year of service does not exceed $3,000.

Description of Proposal

The proposal increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service to $6,000 and adjusts that amount to reflect changes in cost-of-living for years after the first year the proposal is effective. In addition, under the proposal, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

Effective Date

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

[160] Sec. 457.

16. Extended rollover period for the rollover of plan loan offset amounts in certain cases

Present Law

Taxation of retirement plan distributions

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan) is generally includible in gross income, except in the case of a qualified distribution from a designated Roth account or to the extent the distribution is a recovery of basis under the plan or the distribution is contributed to another such plan or an IRA (referred to as eligible retirement plans) in a tax-free rollover.[161] In the case of a distribution from a retirement plan to an employee under age 59½, the distribution (other than a distribution from a governmental section 457(b) plan) is also subject to a 10-percent early distribution tax unless an exception applies.[162]

A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan.[163] The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover").

Employer-sponsored retirement plans are required to offer an employee a direct rollover with respect to any eligible rollover distribution before paying the amount to the employee. If an eligible rollover distribution is not directly rolled over to an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.[164] Employees who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent withheld will remain taxable unless the employee substitutes funds within the 60-day period.

Plan loans

Employer-sponsored retirement plans may provide loans to employees. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan, including that the terms of the loan provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of loan payments with payments not less frequently than quarterly.[165]

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[161] Secs. 402(a) and (c), 402A(d), 403(a) and (b), 457(a) and (e)(16).

[162] Sec. 72(t).

[163] Certain distributions are not eligible rollover distributions, such as annuity payments, required minimum distributions, hardship distributions, and loans that are treated as deemed distributions under section 72(p).

[164] Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

[165] Sec. 72(p).

Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in employee's account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

Description of Proposal

Under the proposal, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. Under the proposal, a qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a section 403(b) plan or a governmental section 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's separation from service, whether due to layoff, cessation of business, termination of employment, or otherwise. As under present law, a loan offset amount under the proposal is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

Effective Date

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

17. Treatment of qualified equity grants

Present Law

Income tax treatment of employer stock transferred to an employee

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services.[166] These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction.

Under these rules, an employee generally must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock). However, if the employee's right to the stock is nonvested at the time the stock is transferred to employee, under section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election.[167] If a proper and timely election under section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). A section 83(b) election is available with respect to grants of "restricted stock" (nonvested stock), and does not generally apply to the grant of options.

In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.[168] An employee's right to stock or other property is transferable if the employee can transfer an interest in the property to any person

[166] Sec. 83. Section 83 applies generally to transfers of any property, not just employer stock, in connection with the performance of services by any service provider, not just an employee. However, the provision described herein applies only with respect to certain employer stock transferred to employees.

[167] Under Treas. Reg. sec. 1.83-2, the employee makes an election by filing with the Internal Revenue Service a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The employee must also provide a copy of the statement to the employer.

[168] See section 83(c)(1) and Treas. Reg. sec. 1.83-3(c) for the definition of substantial risk of forfeiture.

other than the transferor of the property.[169] Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee's income as a result of transfer of the stock.[170] The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.[171]

These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value.[172] Instead, these rules apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee. A section 83(b) election generally does not apply to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, a section 83(b) election may apply. The employer's deduction is generally determined under the rules that apply to transfers of restricted stock, but a special accrual rule may apply under Treasury regulations when the transferred stock is substantially vested.[173]

<u>Employment taxes and reporting</u>

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act ("FICA"), tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[174] Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

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[169] Treas. Reg. sec. 1.83-3(d). In addition, under section 83(c)(2), the right to stock is transferable only if any transferee's right to the stock would not be subject to a substantial risk of forfeiture.

[170] Sec. 83(h).

[171] Treas. Reg. sec. 1.83-6.

[172] See section 83(e)(3) and Treas. Reg. sec. 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

[173] Treas. Reg. sec. 1.83-6(a)(3).

[174] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act ("RRTA"),

FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. Special rules as to the timing and amount of FICA taxes apply in the case of nonqualified deferred compensation, as defined for FICA purposes.[175]

The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the OASDI wage base ($127,200 for 2017); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[176] The employee portion of FICA tax generally must be withheld and, along with the employer portion, remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.[177]

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of $7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the Internal Revenue Service ("IRS").[178] Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes.[179] In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on

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sections 3201-3241, to taxes equivalent to FICA taxes with respect to compensation as defined for RRTA purposes. Sections 3501-3510 provide additional rules relating to all these taxes.

[175] Sec. 3121(v); Treas. Reg. sec. 31.3121(v)(2).

[176] The employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[177] Under section 3501(b), employment taxes with respect to noncash fringe benefits are to be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary of the Treasury ("Treasury"). Announcement 85-113, 1985-31 I.R.B. 31, provides guidance on the application of employment taxes with respect to noncash fringe benefits.

[178] Sec. 3402. Specific withholding rates apply in the case of supplemental wages.

[179] Secs. 6041 and 6051.

Form W-2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.[180]

Statutory options

Two types of statutory options apply with respect to employer stock: incentive stock options ("ISOs") and options provided under an employee stock purchase plan ("ESPP").[181] Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.[182] In addition, generally no deduction is allowed to the employer with respect to the option or the stock transferred to an employee.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs and the employer may be allowed a corresponding deduction in the taxable year in which such disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Employment taxes do not apply with respect to the grant or vesting of a statutory option, transfer of stock pursuant to the option, or a disposition (including a disqualifying disposition) of the stock.[183] However, certain special reporting requirements apply.

Nonqualified deferred compensation

Compensation is generally includible in an employee's income when paid to the employee. However, in the case of a nonqualified deferred compensation plan,[184] unless the

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[180] Employers send Form W-2 information to the Social Security Administration, which records information relating to Social Security and Medicare and forwards the Form W-2 information to the IRS. Employees include a copy of Form W-2 with their income tax returns.

[181] Sections 421-424 govern statutory options. Section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

[182] Under section 56(b)(3), this income tax treatment with respect to stock received on exercise of an ISO does not apply for purposes of the alternative minimum tax under section 55.

[183] Secs. 3121(a)(22), 3306(b)(19), and the last sentence of section 421(b).

[184] Compensation earned by an employee is generally paid to the employee shortly after being earned. However, in some cases, payment is deferred to a later period, referred to as "deferred compensation." Deferred compensation may be provided through a plan that receives tax-favored treatment, such as a qualified retirement

arrangement either is exempt from or meets the requirements of section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined[185]), even if payment will not occur until a later year.[186] In general, to meet the requirements of section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events.

Various exemptions from section 409A apply, including transfers of property subject to section 83.[187] Nonqualified options are not automatically exempt from section 409A, but may be structured so as not to be considered nonqualified deferred compensation.[188] A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A. The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.[189]

Description of Proposal

In general

The provision allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election")

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plan under section 401(a). Deferred compensation provided through a plan that is not eligible for tax-favored treatment is referred to as "nonqualified" deferred compensation.

[185] Treas. Reg. sec. 1.409A-1(d).

[186] Section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Compensation that fails to meet the requirements of section 409A is also subject to an additional income tax of 20% on amounts includible in income, and, along with a potential interest factor tax, applies to increases in the value of the failed compensation each year until it is paid.

[187] Treas. Reg. sec. 1.409A-1(b)(6).

[188] Treas. Reg. sec. 1.409A-1(b)(5). In addition, statutory option arrangements are not nonqualified deferred compensation arrangements.

[189] Sec. 404(a)(5).

with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;[190] (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market;[191] (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes her inclusion deferral election.[192]

An inclusion deferral election is made in a manner similar to the manner in which a section 83(b) election is made. [193] The provision does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election. The provision clarifies that Section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for a section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

An employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock unless at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.[194] For purposes of this requirement, stock purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock with respect to which an inclusion deferral election has been in effect for a longer period than the election with respect to the purchased stock. Thus, in general, in applying the purchase requirement, an individual's deferral stock with respect to which an inclusion deferral election has been in effect for the longest periods must be purchased first. A corporation that has deferral stock outstanding as of

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[190] Thus, for this purpose, the qualified stock is considered transferable if the employee has the ability to sell the stock to the employer (or any other person).

[191] An established securities market is determined for this purpose by the Secretary, but does not include any market unless the market is recognized as an established securities market for purposes of another Code provision.

[192] An inclusion deferral election is revoked at the time and in the manner as the Secretary provides.

[193] Thus, as in the case of a section 83(b) election under present law, the employee must provide a copy of the inclusion deferral election to the employer.

[194] This requirement is met if the stock purchased by the corporation includes all the corporation's outstanding deferral stock.

the beginning of any calendar year and that purchases any of its outstanding stock during the calendar year must report on its income tax return for the taxable year in which, or with which, the calendar year ends the total dollar amount of the outstanding stock purchased during the calendar year and such other information as the Secretary may require for purposes of administering this requirement.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option.[195] In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan solely because of an employee's inclusion deferral election or ability to make an election.

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income as described in (1)-(5) above.

<u>Qualified employee and qualified stock</u>

Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who was a one-percent owner of the corporation at any time during the 10 preceding calendar years,[196] (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2),[197] or (4) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years.[198]

Qualified stock is any stock of a corporation if--

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[195] For purposes of the requirement that an ESPP provide employees with the same rights and privileges, the rules of the provision apply in determining which employees have the right to make an inclusion deferral election with respect to stock received under the ESPP.

[196] One-percent owner status is determined under the top-heavy rules for qualified retirement plans, that is, section 416(i)(1)(B)(ii).

[197] In the case of one-percent owners, this results from application of the attribution rules of section 318 under section 416(i)(1)(B)(i)(II). Family members are determined under section 318(a)(1) and generally include an individual's spouse, children, grandchildren and parents.

[198] These officers are determined on the basis of shareholder disclosure rules for compensation under the Securities Exchange Act of 1934, as if such rules applied to the corporation.

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year,[199] and (2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or restricted stock units ("RSUs"), with the same rights and privileges to receive qualified stock ("80-percent requirement").[200] For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules.[201] However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU.[202]

For purposes of the provision, corporations that are members of the same controlled group[203] are treated as one corporation.

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[199] This requirement continues to apply up to the time an inclusion deferral election is made. That is, under the provision, no inclusion deferral election may be made with respect to qualified stock if any stock of the corporation is readily tradable on an established securities market at any time before the election is made.

[200] In applying the requirement that 80 percent of employees receive stock options or RSUs, excluded employees and part-time employees are not taken into account. For this purpose, part-time employee is defined under section 4980G(d)(4), as an employee who is customarily employed for fewer than 30 hours per week.

[201] Sec. 423(b)(5).

[202] Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

[203] As defined in sec. 1563(a).

Notice, withholding and reporting requirements

Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may (if eligible) elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock), and the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision, as well as of the employee's responsibilities with respect to required withholding. Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers.[204] The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

Effective Date

The provision generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. Under a transition rule, until the Secretary (or the Secretary's delegate) issues regulations or other guidance implementing the 80-percent and employer notice requirements under the provision, a corporation will be treated as complying with those requirements (respectively) if it complies with a reasonable good faith interpretation of the requirements. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017.

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[204] That is, the maximum rate of tax in effect for the year under section 1. The provision specifies that qualified stock is treated as a noncash fringe benefit for income tax withholding purposes.

C. CRAFT Beverage Modernization

1. Exempt the aging period of beer, wine and spirits from UNICAP rules related to interest

Present Law

In general

The uniform capitalization ("UNICAP") rules, which were enacted as part of the Tax Reform Act of 1986,[205] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[206] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property's production period[207] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding $1,000,000.[208] The production period with respect to any property is the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or held for sale.[209] In the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period.[210]

Exceptions from UNICAP

Section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts for the preceding three-taxable year period;[211] such taxpayers are not required to include additional section 263A costs in inventory.

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[205] Sec. 803(a) of Pub. L. No. 99-514 (1986).

[206] Sec. 263A.

[207] See Treas. Reg. sec. 1.263A-12.

[208] Sec. 263A(f).

[209] Sec. 263A(f)(4)(B).

[210] See Treas. Reg. sec. 1.263A-12(d)(1). See also TAM 9327007 (Mar. 31, 1993) (holding that producers of wine must include the time that wine ages in bottles as part of the production period, which concludes when the wine vintage is officially released to the distribution chain).

[211] Sec. 263A(b)(2)(B). No statutory exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers that use the

Another exception exists for taxpayers who raise, harvest, or grow trees.[212] Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any animal or plant having a reproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).[213]

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.[214] Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

<u>Description of Proposal</u>

The proposal would exclude the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the proposal, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

The proposal expires for taxable years beginning after December 31, 2019.

<u>Effective Date</u>

The proposal is effective for interest costs paid or incurred after December 31, 2017.

2. Reduced rate of excise tax on beer

<u>Present Law</u>

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are

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simplified production method and incur total indirect costs of $200,000 or less in a taxable year as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treas. Reg. sec. 1.263A-2(b)(3)(iv). However, the Chairman's Mark of the "Tax Cuts and Jobs Act" proposes to expand the exception for small taxpayers from the uniform capitalization rules. Under the proposal, any producer or reseller that meets the $15 million gross receipts test is exempted from the application of section 263A. See section III.B.4 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017.

[212] Sec. 263A(c)(5).

[213] Sec. 263A(d). See also section III.B.3 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017, which expands the universe of farming C corporations that may use the cash method to include any farming C corporation that meets the $15 million gross receipts test.

[214] Sec. 263A(h).

administered and enforced by the TTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the "CBP") of the Department of Homeland Security (under delegation by the Secretary of the Treasury).

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

The rate of tax on beer is $18 per barrel (31 gallons).[215] Small brewers are subject to a reduced tax rate of $7 per barrel on the first 60,000 barrels of beer domestically produced and removed each year.[216] Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

In the case of a controlled group, the two million barrel limitation for small brewers is applied to the controlled group, and the 60,000 barrels eligible for the reduced rate of tax, are apportioned among the brewers who are component members of such group. The term "controlled group" has the meaning assigned to it by sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in sec. 1563(a).

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Description of Proposal

The proposal lowers the rate of tax on beer to $16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. In general, in the case of a controlled group of brewers, the six million barrel limitation is applied and apportioned at the level of the controlled group. Beer brewed or imported in excess of the six million barrel limit would continue to be taxed at $18 per barrel. In the case of small brewers, such brewers would be taxed at a rate of $3.50 per barrel on the first 60,000 barrels domestically produced, and $16 per barrel on any further barrels produced. The same rules applicable to controlled groups under present law apply with respect to this limitation.

For barrels of beer that have been brewed or produced outside of the United States and imported into the United States, the reduced tax rate may be assigned by the brewer to any importer of such barrels pursuant to requirements set forth by the Secretary of the Treasury in

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[215] Sec. 5051.

[216] Sec. 5051(a)(2).

consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of barrels of beer for which the reduced tax rate has been assigned by a brewer to any importer does not exceed the number of barrels of beer brewed or produced by such brewer during the calendar year which were imported into the United States by such importer; (2) procedures that allow a brewer and an importer to elect whether to receive the reduced tax rate; (3) requirements that the brewer provide any information as the Secretary of the Treasury determines necessary and appropriate for purposes of assignment of the reduced tax rate; and (4) procedures that allow for revocation of eligibility of the brewer and the importer for the reduced tax rate in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in sec 1563(a).[217]

Under rules issued by the Secretary of the Treasury, two or more entities (whether or not under common control) that produce beer marketed under a similar brand, license, franchise, or other arrangement shall be treated as a single taxpayer for purposes of the excise tax on beer.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal is effective for beer removed after December 31, 2017.

3. Simplification of rules regarding records, statements and returns

Present Law

Brewers are required to maintain records and file reports of operations as required by the regulations[218] and are subject to inspection of their premises and records.[219] Special occupational taxes had been imposed on alcohol industry members, including wholesale and retail dealers, but were effectively repealed for taxes due on or after July 1, 2005. However, these persons remain subject to registration and recordkeeping requirements that supplement the operational reporting rules. Brewers file monthly, quarterly, or annual reports of operations (the frequency depends upon the type of operation and its size), which do not include reports of inventory, although inventory records must be kept. Wholesalers and some retailers must keep records, including inventory, but need only register and need not file reports. Civil and criminal

[217] Members of the controlled group may include foreign corporations.

[218] Secs. 5414 and 5555.

[219] Sec. 5553.

penalties, in addition to forfeiture provisions, may apply in the event of non-compliance with the laws and regulations.[220]

Description of Proposal

Under the proposal, the Secretary shall permit a person to employ a unified system for any records, statements, and returns required to be kept, rendered or made under section 5555.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to any calendar quarters beginning after December 31, 2017.

4. Transfers of beer in bond

Present Law

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the TTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the "CBP") of the Department of Homeland Security (under delegation by the Secretary of the Treasury). The rate of tax on beer is $18 per barrel (31 gallons).[221]

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Small domestic brewers are subject to a reduced tax rate of $7 per barrel on the first 60,000 barrels of beer removed each year.[222] Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

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[220] Secs. 5601-91.

[221] Sec. 5051.

[222] Sec. 5051(a)(2).

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Transfer rules and removals without tax

Certain removals or transfers of beer are exempt from tax. Beer may be transferred without payment of the tax between bonded premises under certain conditions specified in the regulations.[223] The tax liability accompanies the beer that is transferred in bond. However, beer may only be transferred free of tax between breweries if both breweries are owned by the same brewer.

Description of Proposal

The proposal relaxes the shared ownership requirement of section 5414. Thus, under the provision, a brewer may transfer beer from one brewery to another without incurring tax, provided that: (i) the breweries are owned by the same person; (ii) one brewery owns a controlling interest in the other; (iii) the same person or persons have a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of the tax.

For purposes of transferring the tax liability pursuant to (iv) above, such relief from liability shall be effective from the time of removal from the transferor's bonded premises, or from the time of divestment, whichever is later.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to any calendar quarters beginning after December 31, 2017.

5. Reduced rate of tax on certain wine

Present Law

In general

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

[223] Sec. 5414.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041)	
“Still wines”[224] not more than 14 percent alcohol	$1.07 per wine gallon[225]
“Still wines” more than 14 percent, but not more than 21 percent, alcohol	$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced rates and exemptions for certain wine producers

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[226] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by sec. 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in sec 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

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[224] A “still wine” is a non-sparkling wine. Most common table wines are still wines.

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

[226] Sec. 5041(c).

Description of Proposal

The proposal modifies the credit against the wine excise tax for small domestic producers, by removing the 250,000 wine gallon domestic production limitation (and thus making the credit available for all wine producers and importers). Additionally, under the proposal, sparkling wine producers and importers are now eligible for the credit. With respect to wine produced in, or imported into, the United States during a calendar year, the credit amount is (1) $1.00 per wine gallon for the first 30,000 wine gallons of wine, plus; (2) 90 cents per wine gallon on the next 100,000 wine gallons of wine, plus; (3) 53.5 cents per wine gallon on the next 620,000 wine gallons of wine.[227] There is no phaseout of the credit.

In the case of any wine gallons of wine that have been produced outside of the United States and imported into the United States, the tax credit allowable may be assigned by the person who produced such wine (the "foreign producer") to any electing importer of such wine gallons pursuant to requirements established by the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirement are to include: (1) a limitation to ensure that the number of wine gallons of wine for which the tax credit has been assigned by a foreign producer to any importer does not exceed the number of wine gallons of wine produced by such foreign producer, during the calendar year, which were imported into the United States by such importer; (2) procedures that allow the election of a foreign producer to assign, and an importer to receive, the tax credit; (3) requirements that the foreign producer provide any information that the Secretary of the Treasury determines to be necessary and appropriate for purposes of assigning the tax credit; and (4) procedures that allow for revocation of eligibility of the foreign producer and the importer for the tax credit in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of sec. 1563(a), except that the phrase "more than 50 percent" is substitute for the phrase "at least 80 percent" in each place it appears in sec 1563(a).[228]

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to wine removed after December 31, 2017.

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[227] The credit rate for hard cider is tiered at the same level of production or importation, but is equal to 6.2 cents, 5.6 cents and 3.3 cents, respectively.

[228] Members of the controlled group may include foreign corporations.

6. Adjust alcohol content level of wine for application of excise taxes

Present Law

In general

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041)	
"Still wines"[229] not more than 14 percent alcohol	$1.07 per wine gallon[230]
"Still wines" more than 14 percent, but not more than 21 percent, alcohol	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced rates and exemptions for certain wine producers

Wineries having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[231] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for

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

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

[231] Sec. 5041(c).

wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in sec. 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Description of Proposal

The proposal modifies alcohol-by-volume levels of the first two tiers of the excise tax on wine, by changing 14 percent to 16 percent. Thus, under the proposal, a wine producer or importer may produce or import "still wine" that has an alcohol-by-volume level of up to 16 percent, and remain subject to the lowest rate of $1.07 per wine gallon.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to wine removed after December 31, 2017.

7. Reduced rate of tax on mead and certain carbonated wines

Present Law

In general

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041)	
"Still wines"[232] not more than 14 percent alcohol	$1.07 per wine gallon[233]
"Still wines" more than 14 percent, but not more than 21 percent, alcohol	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced rates and exemptions for certain wine producers

Wineries having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[234] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in sec 1563(a).

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

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

[234] Sec. 5041(c).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Description of Proposal

The proposal designates mead and certain sparkling wines to be taxed at the lowest rate applicable to "still wine," of $1.07 per wine gallon of wine. Mead is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,[235] which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume. The sparkling wines eligible to be taxed at the lowest rate are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,[236] which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to wine removed after December 31, 2017.

8. Reduced excise tax rates on distilled spirits

Present Law

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.[237] The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.[238]

Distilled spirits are taxed at a rate of $13.50 per proof gallon.[239] Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined

[235] The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

[236] The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

[237] Secs. 5001 (distilled spirits), 5041 (wines), and 5051 (beer).

[238] Secs. 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.

[239] A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. Sec. 5010.

and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into[240] the United States (less certain administrative costs) is transferred ("covered over") to Puerto Rico and the U.S. Virgin Islands.[241] The amount covered over is $10.50 per proof gallon ($13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.[242]

Description of Proposal

The proposal institutes a tiered rate for distilled spirits. The rate of tax is lowered to $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits, $13.34 for all proof gallons in excess of that amount but below 22,130,000 proof gallons, and $13.50 for amounts thereafter. The proposal contains rules so as to prevent members of the same controlled group from receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Importers of distilled spirits are eligible for the lower rates.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to distilled spirits removed after December 31, 2017.

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[240] Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are "brought into" rather than "imported into" the U.S.

[241] Sec. 7652.

[242] Sec. 5011. Section 5011 is administered and enforced by the IRS.

9. Allow transfer of bonded spirits in bottles

Present Law

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.[243] The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.[244]

Distilled spirits are taxed at a rate of $13.50 per proof gallon.[245] Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Additionally, in order to transfer such spirits in bond without payment of tax, such spirits may not be transferred in containers smaller than one gallon.[246] Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into[247] the United States (less certain administrative costs) is transferred ("covered over") to Puerto Rico and the U.S. Virgin Islands.[248] The amount covered over is $10.50 per proof gallon ($13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.[249]

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[243] Secs. 5001 (distilled spirits), 5041 (wines), and 5051 (beer).

[244] Secs. 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.

[245] A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. Sec. 5010.

[246] Sec. 5212.

[247] Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are "brought into" rather than "imported into" the U.S.

[248] Sec. 7652.

[249] Sec. 5011. Section 5011 is administered and enforced by the IRS.

Description of Proposal

The proposal allows distillers to transfer spirits in approved containers other than bulk containers in bond without payment of tax.

The proposal expires for taxable years beginning after December 31, 2019.

Effective Date

The proposal applies to distilled spirits transferred in bond after December 31, 2017.

D. International Tax Reform

1. Modification to source rules involving possessions

Present Law

In general

The U.S. Virgin Islands has an income tax system that "mirrors" the U.S. Code. The U.S. Virgin Islands may also impose certain local income taxes in addition to taxes imposed by the mirror Code. The Code provides rules for coordination of United States and U.S. Virgin Islands taxation.[250] It permits the U.S. Virgin Islands to reduce or remit tax otherwise imposed by the mirror code if the tax is attributable to U.S. Virgin Islands source income or income effectively connected to the conduct of a trade or business in U.S. Virgin Islands.[251] The U.S. Virgin Islands has exercised that authority to provide development incentives for certain types of businesses operating within its borders. Under such initiatives, companies can receive a 90 percent reduction in their tax liability on certain income.

Taxation of individuals

Under the mirror Code, U.S. Virgin Islands citizens and residents are taxable on their worldwide income. A foreign tax credit is allowed for income taxes paid to the United States, foreign countries, and other possessions of the United States. In general, a bona fide resident of the U.S. Virgin Islands is required to file and pay tax only to the possession; compliance with that obligation satisfies any Federal income tax filing obligation. All other U.S. residents or citizens with income from U.S. Virgin Island sources are subject to a dual filing requirement.

In the case of an individual who is a U.S. citizen or alien residing in the United States or the U.S. Virgin Islands, only one tax is computed under the Code. If an individual is a bona fide resident of U.S. Virgin Islands for the entire taxable year, such tax is payable to the U.S. Virgin Islands and no U.S. tax is imposed. Otherwise, a citizen or resident of the United States who has income from sources within the U.S. Virgin Islands must determine the portion of income attributable to the U.S. Virgin Islands and the related tax payable to the U.S. Virgin Islands. The remaining portion is payable to the United States.[252]

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[250] Secs. 932 and 934.

[251] Sec. 934. In general, a bona fide resident of the U.S. Virgin Islands is required to file and pay tax only to the possession. Persons incurring income tax liability in both the United States and the U.S. Virgin Islands are required to file tax returns and pay income tax to both jurisdictions.

[252] Sec. 932(b). See, Internal Revenue Service, *Tax Guide for Individuals with Income from U.S. Possessions* (Pub. 570), 2011, pp. 17-18.

Concerns that U.S. citizens not resident in the U.S. Virgin Islands were improperly claiming residence in the U.S. Virgin Islands[253] or forming entities in the U.S. Virgin Islands in order to recharacterize income earned in the United States as sourced in the U.S. Virgin Islands and claim the 90 percent economic development credit led to legislative changes in 2004.[254] These changes provided a definition of bona fide residence in a possession and rules to determine source of income from possessions. They also impose a requirement that individuals report any change in residency status with respect to a possession during a taxable year.[255]

<u>Taxation of corporations</u>

If a corporation is formed in U.S. Virgin Islands, it is classified as a domestic corporation for U.S. Virgin Islands purposes and a foreign corporation for U.S. tax purposes. Such a corporation is only subject to U.S. tax if it has U.S.-source income or income effectively connected with the conduct of a trade or business in the United States. U.S. Virgin Islands taxes a domestic corporation on its worldwide income, but the company is allowed a foreign tax credit against U.S. Virgin Islands tax for taxes imposed by the United States, foreign countries and other possessions. A corporation that is not formed in U.S. Virgin Islands is treated as a foreign corporation under the U.S. Virgin Islands mirror Code. A company not formed in U.S. Virgin Islands is only subject to U.S. Virgin Islands tax if it has U.S. Virgin Islands source income or income effectively connected with the conduct of a trade or business in U.S. Virgin Islands. The United States taxes its domestic corporations on their worldwide income, but allows a foreign tax credit for taxes imposed by foreign jurisdictions, including U.S. Virgin Islands.

<u>Sourcing rules</u>

As a general rule, the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S. source income or as effectively connected with the

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[253] In Notice 2004-45, 2004-2 C.B. 33 (2004), the IRS described several scenarios in which U.S. persons claimed to have satisfied U.S. liabilities by having filed a return with the U.S. Virgin Islands.

[254] *McHenry v. Commissioner,* 2012 U.S. App. LEXIS 7562 (April 16, 2012) and *Huff v. Commissioner,* 135 T.C. 605 (2010).

[255] Sec. 937. In the preamble to final regulations issued in 2008, certain *de minimis* exceptions are provided for the U.S. citizen or resident with income from U.S. Virgin Island sources, in recognition that “the interaction of section 937 and other sections of the Code relating to the territories requires a balance between implementing the policies Congress intended in section 937(b) while recognizing the territories’ efforts to retain and attract workers and businesses.” T.D. 9391, 73 F.R. 19350 (April 9, 2008); Treas. Reg. Sec. 1.937-2. Those required to report changes in residency status must use Form 8898, “Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession.”

conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.[256]

Description of Proposal

The proposal modifies the sourcing rule in section 937(b)(2) by modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business. The proposal also modifies section 865(j)(3) by providing that capital gains income earned by a U.S. Virgin Islands resident shall be deemed to constitute U.S. Virgin Islands source income regardless of the tax rate imposed by the U.S. Virgin Islands government.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2018.

2. Repeal exclusion applicable to certain passenger aircraft operated by a foreign corporation

Present Law

Income attributable to transportation that begins and ends in the United States is treated as wholly derived from sources in the United States,[257] but transportation income attributable to transportation that begins in, and ends outside, the United States or that begins outside, and ends in, the United States, is generally treated as 50 percent from U.S. source and 50 percent from foreign source.[258] A special rule to determine the source of income from transportation includes a definition of "transportation income." Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use.[259] That definition does not encompass land transport except to the extent that it is directly related to shipping by vessel or aircraft, but regulations extend a similar rule for determining the source of income from transportation services other than shipping or aviation.

A subcategory of transportation income, "U.S. source gross transportation income" is subject to taxation on a gross basis at the rate of four percent.[260] Income is within the scope of this special tax if it is considered to be U.S. source because travel begins or ends in the United

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[256] Sec. 937(b).

[257] Sec. 863(c)(1)

[258] Sec. 863(c)(2).

[259] Sec. 863(c)(3).

[260] Sec. 887(a).

States, is not effectively connected, and is not of a kind to which the exemption from tax applies.[261]

Transportation income from U.S. sources is treated as effectively connected with a foreign person's conduct of a U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation.[262] If the transportation income is effectively connected with conduct of a U.S. trade or business, the transportation income may be subject to the graduated rates, along with transportation income that is from U.S. sources because the transportation both begins and ends in the United States. Under the applicable coordination rule, the four percent tax is not imposed if the income is subject to the provisions of sections 871, or 882.[263]

An exemption from U.S. tax is provided for transportation income of foreign persons from countries that extend reciprocal relief to U.S. persons. A nonresident alien individual with income from the international operation of a ship may qualify, provided that the foreign country in which such individual is resident grants an equivalent exemption to individual residents of the United States.[264] A similar exemption from U.S. tax is provided for gross income derived by a foreign corporation from the international operation of an aircraft, provided that the foreign country in which the corporation is organized grants an equivalent exemption to corporations organized in the United States.[265] To determine whether income from shipping or aviation is eligible for an exemption under section 883, one must examine the extent to which the foreign jurisdiction has extended reciprocity for U.S. businesses; whether the party claiming an exemption is eligible for the tax relief; and the nature of the activities that give rise to the income.

Although tax law treats shipping and aviation similarly, the differences between the two industries and the applicable regulatory regimes produce different tax outcomes.[266] Most countries acknowledge the absolute sovereignty of a state over its airspace as the starting point, with numerous treaties limiting the authority of a foreign airline to enter airspace of another jurisdiction and to land in that jurisdiction. Due to the regulatory framework for aviation, an international flight must either originate or conclude in the airline's owner's resident country,

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[261] Sec. 887(b)(1).

[262] Sec. 887(b)(4).

[263] Sec. 887(a).

[264] Sec. 872(b)(1).

[265] Sec. 883(a)(2).

[266] International Civil Aviation Organization, Supplement 2009 to Doc 8632, "Policies on Taxation in the Field of International Air Transport," 3d edition, 2000, available at https://www.icao.int/publications/Documents/8632_draft_sup_2009.pdf#search=taxation. In the supplement, the United States accepts taxation on the basis of country in which airline is organized, but only with respect to national level taxes, and only with respect to income tax. It does not accept the ICAO limits on excise taxes.

where income tax for the international flight is assessed. As a consequence, in contrast to international shipping, international aviation is not able to be carried out using flags-of-convenience.

A foreign airline that flies into a U.S. city is likely eligible for exemption from US income tax liability with respect to the transportation income, due to treaty exemptions or the reciprocal exemptions available under section 883, even though the cross-border flight generates income that is 50 percent from U.S. sources.[267] Similarly, U.S. airlines flying into foreign countries incur U.S. tax on worldwide income but may be eligible for an exemption similar to the one provided in section 883, depending on the countries to which they fly. They are not authorized to fly a foreign–to-foreign leg of a trip.

To comply with the ownership restrictions imposed by the United States[268] and many of its treaty partners, airlines have contracted to share flight numbers/slots with one another.[269] In that way, an airline can provide a ticket for the entire journey desired by the passenger, and is considered to be the owner of the revenue represented by that ticket, even though all portions of the trip after the initial cross-border flight from its country of residence to the first foreign airport, are operated by an airline in that foreign country. Thus, a passenger from London who purchases a ticket to Altoona, Pa., through JFK, from British Airways, will find it flies on British Airways only on the cross-border leg of the trip. British Airways is not authorized to operate domestic flights within the United States, and instead may ticket its customer on a flight operated by one of its alliance partners, compensating the U.S. airline for the seat. The entire ticket price is income to British Airways, from international transportation, and is eligible for the exemption from U.S. tax. The U.S. airline that operated the domestic flight is taxable on its worldwide income, which includes the "code-share" compensation received from British Airways. The compensation for code-shares is paid in accordance with the various bilateral and multilateral contracts among the airlines, and cleared through a clearing house operated by International Air Transport Organization, an industry trade group.

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[267] Airlines are required to file claim the exemption on a timely income tax return, form 1120F, or risk loss of all deductions otherwise available for computation of income subject to tax under section 882, i.e., resulting in gross basis taxation. Failure to disclose a treaty claim for exemption is subject to a $10,000 penalty. Foreign airlines are required to file forms T-100 with the FAA.

[268] Since the first legislative attempt to regulate the industry, majority domestic ownership of an airline flying in U.S. airspace has been required. The Air Commerce Act of 1926, required 51 percent U.S. ownership, later increased to 75 percent by the Civil Aeronautics Act of 1938, and subsequently codified as part of the legislation forming the Federal Aviation Administration [FAA]. Federal Aviation Act, Pub. L. No. 85-726, 72 Stat. 731, codified at 49 USC 1301-1557 (1988). The definition of citizenship for purposes of determining U.S. ownership is found at 49 USC 40102(a)(15)(C), and includes U.S. partnerships in which the majority of partners are U.S. persons, or corporations that are U.S. owned.

[269] See, generally, GAO, *Issues Relating to Foreign Investment and Control of US Airlines*, GAO-04-34R, October 30, 2003 (updating an earlier report, *Airline Competition: Impact of Change Foreign Investment and Control Limits on U.S. Airlines*, GAO/RCED-93-7, December 1992).

Description of Proposal

This proposal modifies the reciprocal exemption from U.S. tax under section for gross income derived by a foreign corporation from the international operation of an aircraft by adding two additional requirements. Under the proposal, the exemption from U.S. tax under section 883(a)(2) shall not apply if: (1) the foreign corporation engaged in the international operation of an aircraft is headquartered in a foreign country without an income tax treaty between the United States and such foreign country, and (2) the foreign country has fewer than two arrivals and departures, per week, from major passenger airline carriers headquartered in the United States. For these purposes, an aircraft that lands in one country and subsequently departs from that country is treated as having engaged in one arrival and departure.

Effective Date

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

IV. REVENUE-DEPENDENT REPEALS

Description of Proposal

The Chairman's Mark is modified by adding a proposal that repeals the proposals described in sections II.B.4, II.B.6, II.C.1, II.C.2, II.C.5[270], and III.B.1, of this document if, as determined by the Secretary of the Treasury from amounts reported in the Financial Report of the United States Government, cumulative aggregate on-budget Federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds $27,487,000,000,000 by an amount greater than or equal to $900,000,000,000.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2025.

[270] The revenue-dependent repeals proposal does not repeal the component of the modification to the Chairman's Mark described in section II.C.5 of this document that excludes amounts paid or incurred for certain services.