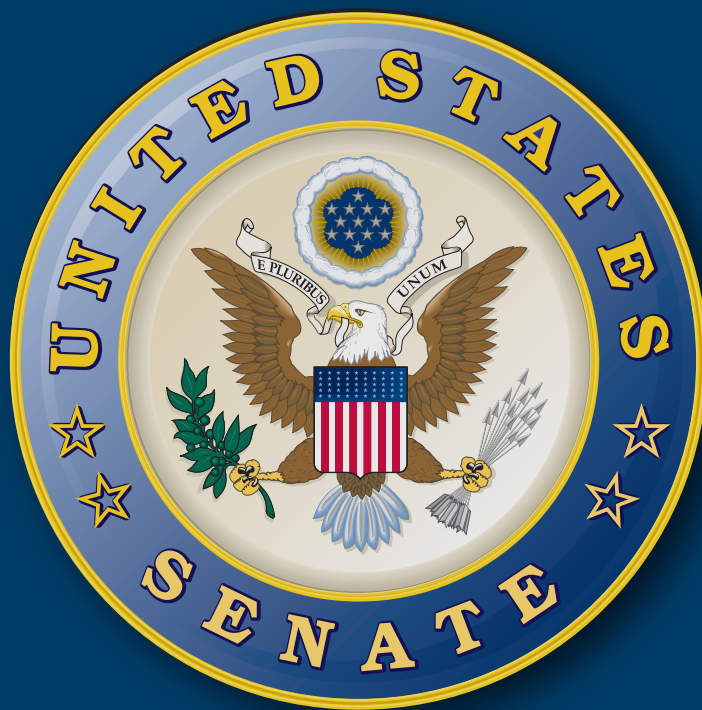


United States Senate Committee on Finance

The Business Income Tax Bipartisan Tax Working Group Report



July 2015

**REPORT OF THE BUSINESS
INCOME TAX WORKING GROUP**

TO THE

**UNITED STATES SENATE
COMMITTEE ON FINANCE**

JULY 2015

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Foreword by Co-Chairs

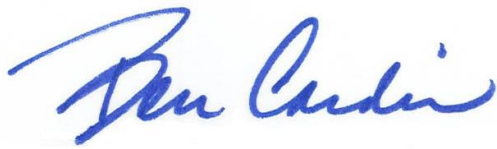
Earlier this year, Chairman Hatch and Ranking Member Wyden asked if we would co-chair the Finance Committee's tax reform working group focused on business tax issues, an effort designed to examine the many challenges and opportunities posed by reforming how America taxes business income. We accepted this request because we believe that American businesses deserve a better tax system than the current tax code. We view the working group process as a demonstration of the importance that the chairman and ranking member place on enacting tax reform, a goal that we share. And we took on the challenge of co-chairing the working group knowing that progress toward real tax reform will not be fast or easy, but rather will entail thoughtful deliberation around a number of very complex and difficult decisions.

What follows is the report of the Business Income Tax Working Group. This report is the result of meetings amongst the members and staff of the group over the past few months. It reflects member and staff discussions over how to fairly and responsibly improve our nation's taxation of business income in an effort to boost our economy, create good-paying jobs, and raise incomes for American workers. While the report does not suggest a specific business tax reform plan, given the limited time available, we have attempted to explore those areas we consider to be the "threshold issues" of business tax reform. Our analysis largely comes in the form of principles, considerations and options, in addition to specific recommendations. Additionally, an addendum to the report prepared with the assistance of the Joint Committee on Taxation ("JCT") provides the technical details of a number of the proposals discussed in the report.

We approach tax reform from different political parties and different sides of the ideological spectrum. And yet we agree that tax reform is essential because our current tax system is too complex, unnecessarily distorts economic decision-making and is inadequate to the task of collecting revenue in a manner that puts American businesses, of all sizes, in a position to succeed in a competitive global economy. We are hopeful that this report will foster a discussion around the difficult trade-offs inherent in business tax reform, as well as a conversation about the type of business tax system we ought to have. We appreciate that real and meaningful tax reform is likely to be a once-in-a-lifetime legislative accomplishment, and one that we need to ensure we get right. Simply put, Americans deserve a business tax system designed for the 21st century economy and one that is up to the task of addressing the challenges that will face American business owners and entrepreneurs in the decades to come.

We want to thank the members of the Business Income Tax Working Group: Senator Pat Roberts (R-KS), Senator Debbie Stabenow (D-MI), Senator Richard Burr (R-NC), Senator Tom Carper (D-DE), Senator Johnny Isakson (R-GA), Senator Bob Casey (D-PA), Senator Rob Portman (R-OH), Senator Mark Warner (D-VA), Senator Pat Toomey (R-PA), Senator Bob Menendez (D-NJ), Senator Dan Coats (R-IN) and Senator Bill Nelson (D-FL). Their participation in our

sessions with the JCT staff informs the views expressed in the report. The same can be said of the tax staffers for these senators, who no doubt spent countless hours preparing their bosses to discuss a wide variety of business tax issues. We especially want to thank Tom Barthold and the staff of the JCT, without whom this report would not have been possible. Their tireless efforts to cover nearly every aspect of business taxation in the education sessions with members and staff were essential to this endeavor. Finally, we want to thank the more than 300 stakeholders who submitted formal comments to the working group. The continued participation of stakeholders will be vital as Congress takes up the challenge of tax reform.

A handwritten signature in blue ink that reads "Ben Cardin". The signature is fluid and cursive, with the first name "Ben" being particularly prominent.

U.S. Senator Benjamin L. Cardin (D-MD)
Co-Chair

A handwritten signature in blue ink that reads "John Thune". The signature is cursive and includes a long horizontal flourish at the end.

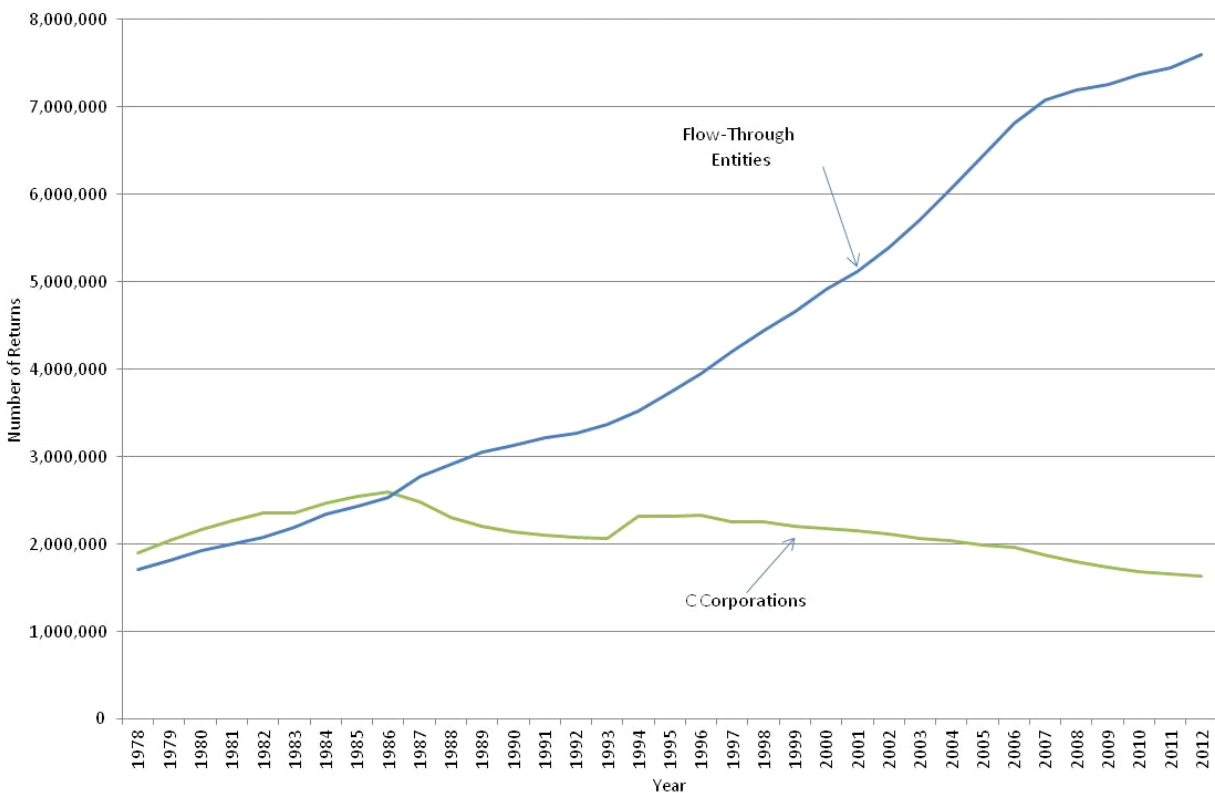
U.S. Senator John Thune (R-SD)
Co-Chair

Introduction

Comprehensive reform of our system for taxing business income is long overdue. Our current tax system is cumbersome for businesses large and small, imposing considerable compliance costs. It is estimated that the administrative and compliance costs in the corporate tax system exceed \$40 billion per year, which is equivalent to more than 12 percent of revenue collected.¹ These are dollars that could be better spent on investments in businesses, such as buying a new piece of equipment or hiring an additional worker. A more streamlined tax system would free up resources for America's businesses, especially small businesses, which could result in higher productivity and higher wages.

Our tax system also promotes inefficiency by incentivizing businesses to make decisions based on tax considerations, rather than for business reasons. This has manifested itself in the area of business entity choice. Consider that over the past few decades, since enactment of the Tax Reform Act of 1986, there has been movement en masse away from C-corporation status to status as an LLC, S corporation, partnership, or other pass-through business.

Figure 1: Number of C Corporation Returns Compared to Sum of S Corporation and Partnership Returns, 1978-2012



Source: Internal Revenue Service, Statistics of Income published and unpublished data.

These pass-through businesses are a vital part of our economy, but the tax code should not so heavily tilt business owners towards one type of business structure over another. A better business tax system would have as little impact on business decision-making as possible. Or, as one recent study put it, *“An ideal tax system would create the fewest distortions to business decisions about capital and labor, except to promote the types of activities that generate positive spillovers (e.g. research and development).”*²

Our system for taxing business income is also woefully out of date and out of sync with our global competitors. America today retains the dubious distinction of having the highest statutory corporate tax rate among advanced economies at roughly 39 percent (including state taxes). The Organisation of Economic Development (“OECD”) average corporate tax rate (excluding the U.S.) is 24.6 percent, a more than 14 percentage point differential with the U.S. average combined federal and state rate. Some of America’s major competitors, such as Canada and the United Kingdom, have been particularly aggressive in lowering their corporate tax rates.

A high tax rate can put American companies at a disadvantage when competing for business opportunities in the markets beyond our borders, where more than 95 percent of global consumers reside. In addition, while international tax issues are within the purview of the International Tax Working Group, it is worth noting that many commentators have cited the fact that the U.S. is one of only a handful of OECD nations that maintain a worldwide tax system as an additional factor adversely impacting the competitiveness of American businesses.

Additionally, our business tax system too often fosters uncertainty, making it more difficult than necessary for business owners to plan for the future. Consider that more than 30 business tax provisions, often known as “tax extenders,” expire periodically, adding complexity and uncertainty to many business decisions. Small business owners, for example, face cost recovery rules under section 179 of the tax code that can vary wildly from year to year based on congressional action, or lack thereof. In 2014, the section 179 expensing limit was \$25,000 for more than 11 months of the year, until Congress enacted a \$500,000 limit in December retroactive to the beginning of the year. Similarly, manufacturers and other capital-intensive industries face cost-recovery rules that have fluctuated due to the expiration of “bonus depreciation,” which stood at 100 percent in 2011 and 50 percent from 2012 to 2014 – but which was not extended retroactively until the provision had been expired for an entire year (2012) and nearly an entire year (2014). Because of this complexity and uncertainty, our business tax system can result in unfair treatment for different businesses, business owners, and workers. A better business tax system would allow businesses to plan future investments by providing them consistent tax treatment year after year, while also providing the government with a stable source of revenue.

In short, while it will entail many difficult decisions, the need for business tax reform only grows more urgent with each passing year. Recent history has demonstrated that every year that America waits to address reform will result in more business activity in those nations that have implemented more competitive tax systems, it will mean more and more U.S.-based companies acquired by their foreign-based competitors, and it will mean U.S. economic growth that continues to be hampered by our burdensome and antiquated tax system.

A well-designed reform of America's system of taxing business income has the potential to promote economic growth. For example, a recent study commissioned by the National Association of Manufacturers estimated that a pro-growth tax reform plan (including lower taxes on pass-through businesses as well as international reforms) would add almost 1 percentage point (about 0.9 percent) to GDP growth on an annual basis. This would result in more than \$12 trillion in increased U.S. GDP growth between 2015 and 2024, and more than 6.5 million additional jobs over the period.³ Estimates will, of course, vary by the details of reform proposals, the methodologies used to evaluate growth effects, and the assumptions underlying those different methodologies, which can make predictions on growth, especially in the long term, somewhat uncertain. Nonetheless, reforming our outdated tax system provides a unique opportunity to better encourage economic growth and job creation.

Higher GDP growth from pro-growth tax reform would also mean higher government revenue. According to the Congressional Budget Office ("CBO"), a sustained increase in the growth rate of U.S. GDP of 1 percent over 10 years would result in deficit reduction of \$3.3 trillion over that period.⁴

As important, business tax reform can result in not just higher economic growth and more jobs, but also higher wages. This is because workers bear some of the cost of the corporate income tax in the form of lower wages, although economists disagree to what extent. One CBO analysis estimated that U.S. domestic labor bears 70 percent of the U.S. corporate tax,⁵ while other economists find that, depending on assumptions, U.S. domestic labor bears a lower proportion (e.g., one-third).⁶ Whatever the exact percentage, it stands to reason that as capital becomes more mobile across borders, it is American workers who will increasingly bear a larger share of the burden of the high U.S. corporate tax rate.

Given the promise of business tax reform – better economic growth, more jobs, higher wages, predictability for taxpayers, and stable revenues – it should be no surprise that Democrats and Republicans alike are calling for an update of the U.S. business tax system. Like numerous economists and business leaders, they recognize that our more than 100-year-old tax code is due for more than a tune-up nearly 30 years after the last successful comprehensive tax reform effort (the Tax Reform Act of 1986)—it is in need of a complete overhaul.

The Principles of Business Tax Reform

The Business Income Tax Working Group arrived at a number of principles that should drive reform. The principles below are by no means an exhaustive list, but hopefully they can help policymakers organize and prioritize a business tax reform effort.

Business tax reform should:

1. Create an internationally competitive and modern business tax code that encourages job creation and economic growth, including by lowering business tax rates

If there is one element of business tax reform that appears to have very broad support, it is the need for a substantially lower corporate tax rate. Despite the multitude of differences in previous tax reform proposals, they have all included a lower corporate tax rate. This is, no doubt, a reflection of the very high U.S. corporate tax rate relative to our major competitors and recognition of the downward trend of corporate tax rates in recent years.

Simply put, the U.S. corporate tax rate needs to be competitive with the nations with whom we compete in the global economy. The OECD median statutory corporate tax rate is 25 percent, a reduction of 5 percentage points since 2004. But the lower corporate tax rates adopted by OECD nations are not the exception, but rather the norm. According to KPMG, the EU average statutory corporate tax rate stands at just over 22 percent, while the Asia average rate stands at just under 22 percent. In fact, the global statutory corporate tax rate average stands at just under 24 percent as of 2015.⁷ Even Japan, for years the nation with the highest statutory tax rate, has reduced its rate substantially, reaching roughly 33 percent as of 2015.⁸

All of the notable tax reform proposals of recent years have attempted to lower the corporate tax rate in a meaningful way. The tax reform plan by Senators Ron Wyden (D-OR) and Dan Coats (R-IN) (formerly Senators Wyden and Gregg (R-NH)) would reduce the corporate tax rate to 24 percent. The Tax Reform Act of 2014, introduced by then Ways and Means Chairman Dave Camp (R-MI-4), would have reduced the corporate tax rate to 25 percent. Similarly, Senators Marco Rubio (R-FL) and Mike Lee (R-UT) have outlined a tax reform proposal that would tax business income at a 25 percent rate. President Obama's FY 2016 budget proposed a domestic rate of 28 percent, lowered to 25 percent for manufacturing corporations. The 2005 President's Advisory Panel on Tax Reform, co-chaired by former Senators Connie Mack (R-FL) and John Breaux (D-LA), recommended a business tax rate of 30 percent. Despite real differences in how these

plans arrived at a lower rate, they all recognize that a hallmark of successful business tax reform will be lowering the corporate tax rate significantly.

2. Address structural biases and promote investment

There are numerous structural issues to be addressed in business tax reform. Major issues addressed in this report include attempting to lessen the role that the tax system plays in choice of business entity, making sure that pass-through businesses are not harmed by efforts to lower the corporate tax rate, addressing the tax code's current bias in favor of debt financing over equity financing, and reducing the tax code's bias against savings and investment in the United States. A business tax reform effort that ignores these important structural issues will fall short of real and meaningful reform, and a business income tax code that does not adequately promote investment could hamper U.S. economic growth.

3. Promote American innovation

There is broad agreement that a major challenge facing the American economy today and in the coming years will be its ability to innovate in a way that keeps American businesses ahead of the technology curve, especially as other nations continue to promote domestic innovation and attract the activities and income related to intellectual property ("IP"). A modernized business tax code should reflect an understanding that U.S. businesses today face competition from Beijing to Bangalore to Berlin. Americans can no longer take for granted that the next revolutionary technology will be created within our borders, but our tax code should do everything possible to encourage that outcome.

Proposals in this area discussed in the report include strengthening and making permanent the research and experimentation ("R&E") tax credit, creating an innovation box tied to domestically held and developed IP, and incentives for energy production that are technology and source neutral.

4. Remove complexity, encourage certainty and improve the taxpayer experience

There are numerous issues that can be addressed as part of business tax reform, such as simplification measures that make it easier for businesses to file, tax reporting measures that make it easier for business owners to determine their tax liability earlier in the filing season, or measures that assist non-profit entities doing good works in our communities. While these measures may be deemed as "smaller" or less substantial, they are nevertheless important. And unlike some of the "bigger" issues in business tax reform,

these measures could potentially move stand-alone, apart from the challenges and complications of the broader reform effort. The report explores some of these measures.

Other Considerations in Developing the Report

From the outset, the working group recognized that the issues considered by its members could not be viewed in a vacuum. The working group's discussions were necessarily limited by the jurisdiction set forth by the committee. Despite (and in some cases, because of) the broadness of that jurisdiction, many of the issues discussed potentially affect other areas of the Internal Revenue Code.

Because of this overlap, the committee's consideration of the issues discussed in this report should depend on the reports submitted by the four other tax reform working groups. If the committee's goal is to use these reports to tackle comprehensive tax reform, it should also depend on the broader trade-offs between the issues considered by each working group.

As mentioned above, this report does contain more discrete provisions and issues that could warrant standalone committee consideration (for instance, provisions related to tax administration). However, the members of the working group urge the committee not to selectively focus on any given item without considering the tax reform principles outlined in this report and principles previously submitted by members of the Finance Committee.

In producing this report, the intent of the working group was not to provide the committee a comprehensive, "approved" list of tax reform options that could be selected or disregarded unilaterally. Instead, the report is aimed at providing a non-exhaustive compilation of issues and provisions that the working group believes warrant further committee review as tax reform efforts continue.

Finally, the working group would like to express appreciation for the comments submitted by stakeholders throughout the tax reform working group process, including the formal submissions to the committee in April. These comments were helpful in guiding the deliberations on the issues discussed in this report.

The Challenges of Business Tax Reform

If tax reform of any flavor were an easy endeavor, it would have been accomplished long ago. It should be understood that meaningful tax reform will be a difficult undertaking, requiring not only a keen understanding of the substantive issues, but also an ability to navigate often politically difficult choices. That said, business tax reform is achievable—but only if first there is a proper understanding of some of the key challenges facing such an undertaking.

Overarching challenges include:

1. U.S. Fiscal Situation

Any tax reform effort is arguably more easily achievable under a balanced or surplus budget situation. Unfortunately, today America finds itself far from such a situation. With deficits running in the hundreds of billions of dollars annually, it is generally understood that tax reform as an effort in significant net tax relief is not feasible.

The Obama Administration's FY2016 budget includes a reserve for business tax reform that is "revenue neutral in the long run." Likewise, the budget resolution adopted by Congress earlier this year includes a call for revenue neutral tax reform. The key difference between the parties on business tax reform, as reflected in the Obama Administration's view and the budget resolution, has been whether "revenue neutral" is measured over the standard budget period of 10 years, or whether this should be measured over a longer period of time to reflect the fact that some elements of business tax reform can have relatively smaller fiscal impacts over the budget window than over a longer time horizon.

More specifically, as discussed later in this report, some tax policy changes have revenue effects that are permanent while others, such as changes to cost recovery, tend to have timing effects. It is the view of some proponents of tax reform that pro-growth tax reform will spur additional economic activity, thus generating higher government revenues and offsetting the impact of timing changes in the long run. However, others take the position that business tax reform should be revenue neutral under conventional scoring over a time horizon beyond the budget window, or have expressed concerns that a revenue-neutral tax reform within the budget window—depending on the provisions used to achieve revenue neutrality—could lead to larger deficits outside of the budget window.

While an improving U.S. fiscal situation in the near term could help to narrow these differing viewpoints, it is unlikely to resolve the issue. As such, the differences on this point are only likely to be resolved once tax reform is undertaken, as a part and parcel of the give and take necessary to achieve a successful result.

2. Constraints of 1986-style Reform

While the Tax Reform Act of 1986 can and should be a reference point for the next tax reform effort, it is important to bear in mind that the circumstances today are in many ways different than they were 30 years ago. While the 1986 reform did “lower the rates and broaden the base,” it did so in ways that today’s process may not be able to replicate. For example, it is important to remember that the 1986 bill was a net tax increase on businesses used to lower tax rates on individuals. This was at a time when very high individual rates were creating momentum for reform. Arguably today the situation is reversed, but Congress is highly unlikely to raise taxes on individuals in order to fund business tax relief.

Additionally, the 1980s were a time of significant tax shelters, due to such high individual rates, and it is not surprising that a major pay-for in tax reform was eliminating many of these shelters. While there are no doubt abuses in the current system, Congress is unlikely to find a pay-for of the magnitude of the passive loss rules, for instance. In fact, today there is commitment to a revenue-neutral exercise but a lack of serious consensus around base broadening, as discussed later in the report.

That is not to say that the 1986 effort does not hold important lessons for tax reform today; it certainly does. First and foremost it demonstrates what can be accomplished even under very difficult circumstances. The Tax Reform Act of 1986 was accomplished at a time of large and persistent budget deficits, a dangerous world abroad, and a highly divided political environment at home. Unfortunately, some things haven’t changed.

3. Need for Leadership and Bipartisanship

It will take significant and persistent engagement by the administration – this administration or a future administration – with Congress in order for tax reform to gain the kind of momentum necessary for success. In this respect, the tax reform dynamic today isn’t that different from the 1986 effort. As former Senator Bill Bradley noted in his appearance before the Finance Committee earlier this year, it was the Reagan Administration’s focus on tax reform – and the consistent engagement of Treasury officials with Congress – that played an essential role in making tax reform successful.

Simply put, tax reform is not likely to happen unless there is a sustained push on both ends of Pennsylvania Avenue. It is unlikely to gain momentum simply because any single member or group of members of Congress unveils a tax reform plan, whether a rank and file member or a chairman of one of the relevant committees. Neither Congress nor the administration can make this happen on its own; it will need to be a joint work product.

Similarly, an undertaking as substantial and important as tax reform can only be accomplished with some degree of bipartisanship. This will require a willingness by members of both parties to demonstrate flexibility and to think creatively. The recent informal bipartisan sessions of the Finance Committee have fostered closer working relationships between the members of the committee--not an insignificant factor if tax reform is to be achieved.

Additionally, successful tax reform will require leadership by stakeholders, particularly CEOs and others in the business community who have much at stake in the reform effort. The leadership required will mean business leaders who are willing to put aside their parochial interests for the good of the country; in other words, those business leaders and other stakeholders who are able to grasp the big picture of greater U.S. economic growth, continued American economic leadership around the world, and a more prosperous future for the next generation.

Too often stakeholders have agreed that tax reform is important in theory, only to then spend all of their time, resources and effort advocating for their special interest provision in the tax code. Those groups who have consistently voiced support for tax reform, even if it means giving up specific tax preferences they hold dear, are to be commended.⁹ It will take continued leadership in the business community to make business tax reform a reality.

While there are numerous challenges involved in business tax reform, there are two major challenges that are truly “threshold issues,” in the sense that an inability to effectively surmount these challenges makes meaningful business tax reform all but impossible. As such, the working group spent much of its time exploring options for addressing these two key challenges: lowering the corporate tax rate and treating pass-through businesses equitably.

1. The Challenge of Lowering the Corporate Rate

In recent discussions on comprehensive tax reform, much of the focus has been on the U.S. corporate tax rate. As shown in Table 1 below, the U.S. has the highest combined statutory corporate tax rate of the member countries of the OECD.

The recent trend across the OECD countries has been a reduction in statutory corporate tax rates. Thirty-one out of 34 OECD nations have lowered their corporate tax rate since 2000. The OECD median top combined statutory corporate tax rate in 2004 was 30 percent; in 2014, the median was 25 percent. As mentioned above, many of the largest decreases have come from major U.S. competitors. Canada’s corporate tax rate, for example, has dropped from 33.93 percent in 2006 to 26.3 percent as of 2015, while the UK rate has gone from 30 percent as of 2006 to 20 percent as of 2015.

Table 1: Top Corporate Income Tax Rates in the OECD

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Australia	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Austria	34.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Belgium	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Canada	34.4	34.2	33.9	34.0	31.4	31.0	29.4	27.6	26.1	26.3	26.3
Chile	17.0	17.0	17.0	17.0	17.0	17.0	17.0	20.0	20.0	20.0	20.0
Czech Republic	28.0	26.0	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0
Denmark	30.0	28.0	28.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	24.5
Estonia	26.0	24.0	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0
Finland	29.0	26.0	26.0	26.0	26.0	26.0	26.0	26.0	24.5	24.5	20.0
France	35.4	35.0	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4
Germany	38.9	38.9	38.9	38.9	30.2	30.2	30.2	30.2	30.2	30.2	30.2
Greece	35.0	32.0	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0	26.0
Hungary	16.0	16.0	17.3	20.0	20.0	20.0	19.0	19.0	19.0	19.0	19.0
Iceland	18.0	18.0	18.0	18.0	15.0	15.0	18.0	20.0	20.0	20.0	20.0
Ireland	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Israel	35.0	34.0	31.0	29.0	27.0	26.0	25.0	24.0	25.0	25.0	26.5
Italy	33.0	33.0	33.0	33.0	27.5	27.5	27.5	27.5	27.5	27.5	27.5
Japan	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	37.0	37.0
Korea	29.7	27.5	27.5	27.5	27.5	24.2	24.2	24.2	24.2	24.2	24.2
Luxembourg	30.4	30.4	29.6	29.6	29.6	28.6	28.6	28.8	28.8	29.2	29.2
Mexico	33.0	30.0	29.0	28.0	28.0	28.0	30.0	30.0	30.0	30.0	30.0
Netherlands	34.5	31.5	29.6	25.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0
New Zealand	33.0	33.0	33.0	33.0	30.0	30.0	30.0	28.0	28.0	28.0	28.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Portugal	27.5	27.5	27.5	26.5	26.5	26.5	26.5	28.5	31.5	31.5	31.5
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0	22.0
Slovenia	25.0	25.0	25.0	23.0	22.0	21.0	20.0	20.0	20.0	17.0	17.0
Spain	35.0	35.0	35.0	32.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Sweden	28.0	28.0	28.0	28.0	28.0	26.3	26.3	26.3	26.3	22.0	22.0
Switzerland	24.1	21.3	21.3	21.3	21.2	21.2	21.2	21.2	21.2	21.1	21.1
Turkey	33.0	30.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
United Kingdom	30.0	30.0	30.0	30.0	28.0	28.0	28.0	26.0	24.0	23.0	21.0
United States	39.3	39.3	39.3	39.3	39.3	39.1	39.2	39.2	39.1	39.1	39.1
OECD Median	30.0	29.0	28.0	27.0	26.8	26.0	25.8	25.5	25.0	25.0	25.0

Source: OECD Tax Database.

To put these trends in context, the working group examined the amount collected in and the composition of U.S. taxes compared to our OECD competitors. While the U.S. is, in general, a high income tax country, it is not necessarily a high tax country overall, in terms of total receipts collected as a percentage of GDP. In other words, the size of the tax “pie” in the United States is smaller than its OECD competitors, reflecting, at least in part, a lower level of U.S. government spending relative to other nations.¹⁰

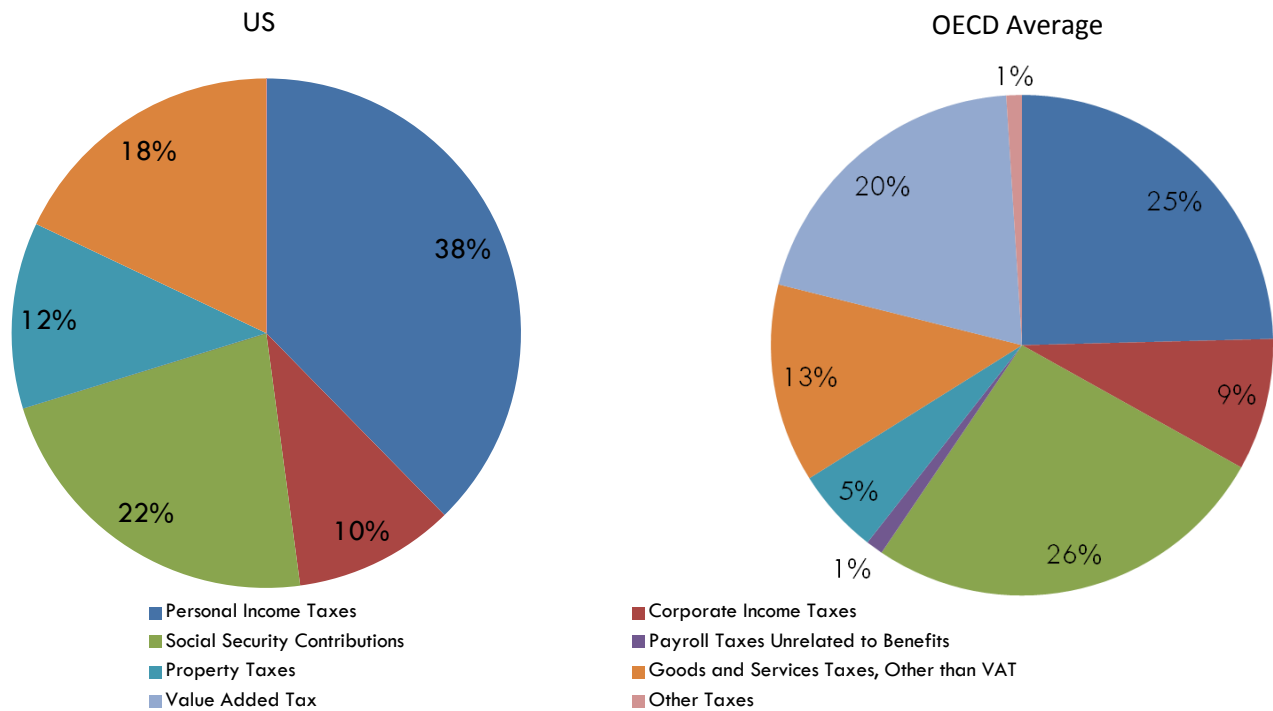
Table 2: Tax Revenue Collected as a Share of GDP in OECD Countries, by Revenue Source, 2012

	Taxes on Personal Income, Profits, and Gains	Taxes on Corporate Income and Capital Gains	Social Security Contributions	Payroll Taxes	Taxes on Property	VAT or GST	Other Taxes on Goods and Services	Other Taxes (Including Other Income Taxes)	Total
Australia	10.7%	5.2%	0.0%	1.4%	2.4%	3.3%	4.4%	0.0%	27.3%
Austria	9.5%	2.2%	14.2%	2.9%	0.6%	7.8%	3.8%	0.8%	41.7%
Belgium	12.2%	3.0%	14.1%	0.0%	3.3%	6.9%	4.0%	0.3%	44.0%
Canada	11.2%	2.9%	4.8%	0.7%	3.3%	4.2%	3.3%	0.4%	30.7%
Chile	1.5%	5.8%	1.4%	0.0%	0.9%	8.1%	2.6%	1.1%	21.4%
Czech Republic	3.6%	3.3%	14.7%	0.0%	0.5%	7.1%	4.4%	0.2%	33.8%
Denmark	24.0%	3.0%	0.9%	0.3%	1.8%	9.7%	5.1%	2.5%	47.2%
Estonia	5.3%	1.4%	11.3%	0.0%	0.3%	8.6%	5.0%	0.2%	32.1%
Finland	12.5%	2.1%	12.6%	0.0%	1.2%	9.0%	5.1%	0.1%	42.7%
France	7.9%	2.5%	16.5%	1.4%	3.8%	6.8%	4.0%	1.2%	44.0%
Germany	9.3%	1.8%	13.9%	0.0%	0.9%	7.1%	3.3%	0.2%	36.5%
Greece	7.0%	1.1%	10.8%	0.0%	1.9%	7.1%	5.6%	0.2%	33.8%
Hungary	5.3%	1.3%	12.6%	0.9%	1.2%	9.1%	7.7%	0.3%	38.5%
Iceland	13.2%	1.9%	3.7%	0.3%	2.5%	8.1%	4.3%	1.3%	35.3%
Ireland	9.1%	2.3%	4.2%	0.2%	1.9%	5.9%	3.6%	0.1%	27.3%
Israel	5.5%	2.7%	5.1%	1.2%	2.7%	7.3%	4.3%	1.0%	29.7%
Italy	11.7%	2.8%	13.1%	0.0%	2.7%	6.0%	5.0%	1.5%	42.8%
Japan	5.5%	3.7%	12.2%	0.0%	2.7%	2.7%	2.6%	0.1%	29.4%
Korea	3.7%	3.7%	6.1%	0.1%	2.6%	4.3%	3.5%	0.8%	24.8%
Luxembourg	8.4%	5.2%	11.3%	0.0%	2.7%	7.0%	3.8%	0.1%	38.5%
Mexico	2.6%	1.9%	2.9%	0.3%	0.3%	3.7%	6.9%	1.0%	19.6%
Netherlands	7.3%	1.9%	15.0%	0.0%	1.1%	6.5%	4.1%	0.4%	36.3%
New Zealand	12.5%	4.7%	0.0%	0.0%	2.1%	9.9%	2.8%	1.2%	33.1%
Norway	9.9%	10.5%	9.6%	0.0%	1.2%	7.7%	3.4%	0.0%	42.3%
Poland	4.5%	2.1%	12.1%	0.3%	1.2%	7.1%	4.5%	0.2%	32.1%
Portugal	5.8%	2.7%	8.8%	0.0%	1.2%	8.2%	4.1%	0.3%	31.2%
Slovak Republic	2.6%	2.4%	12.3%	0.0%	0.4%	6.0%	3.9%	0.4%	28.1%
Slovenia	5.7%	1.2%	14.9%	0.1%	0.6%	8.0%	5.8%	0.2%	36.5%
Spain	7.4%	2.1%	11.5%	0.0%	2.0%	5.3%	3.2%	0.5%	32.1%
Sweden	11.9%	2.6%	10.0%	4.4%	1.0%	8.9%	3.4%	0.2%	42.3%
Switzerland	8.5%	2.8%	6.7%	0.0%	1.8%	3.5%	2.7%	0.9%	26.9%
Turkey	4.0%	2.0%	7.5%	0.0%	1.2%	5.8%	6.7%	0.5%	27.6%
United Kingdom	9.1%	2.7%	6.3%	0.0%	3.9%	6.9%	4.0%	0.2%	33.0%
United States	9.2%	2.5%	5.5%	0.0%	2.9%	0.0%	4.4%	0.0%	24.4%
OECD Average	8.6%	2.9%	9.0%	0.4%	1.8%	6.8%	3.4%	0.8%	33.7%

Source: OECD, *Revenue Statistics: 1965-2013* (2014).

In addition, the U.S. composition of those collections differs from OECD countries. The most pronounced difference is the extent to which, on average, the OECD relies on consumption tax collections (collections from goods and services taxes or value-added taxes). As a result, across all levels of government, approximately half of the tax collected in the U.S. comes from individual or corporate income taxes.¹¹ On average, in the OECD, that number is closer to one-third.

Figure 2: Taxes by Source, All Levels of Government, 2012



Source: OECD.

As stated above, one of the working group’s principles of business tax reform is to create an internationally competitive and modern business tax code. As our competitors reduce corporate income tax rates, despite the non-tax advantages that the U.S. offers, it may become more difficult for the U.S. to attract jobs and investment while retaining the highest statutory corporate income tax rate in the OECD. For that reason, among others, recent tax reform plans have placed the top federal statutory corporate income tax rate in the range of 24 to 30 percent.

Reducing the corporate tax rate to these levels poses significant challenges, especially within the constraints of revenue-neutral, “1986-style” tax reform. To get a clear picture of the scope of this problem, Table 3 presents the revenue effects of changing the corporate rate by one percentage point over the ten-year budget window.

Table 3: Joint Committee Staff Estimate of Revenue Effect of One Percentage Point Increase in Statutory Corporate Income Tax Rates

Billions of dollars	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2015-2019	2015-2024
Change in Revenues	7	10	10	10	10	10	11	11	12	12	46	102

Source: Joint Committee on Taxation staff estimate as reproduced in CBO, Options for Reducing the Deficit: 2015 to 2024, November 20, 2014.

Note: The option would take effect in January 2015. Estimates are relative to CBO’s April 2014 baseline projections.

As Table 3 indicates, a one percentage point change in the corporate tax rate alone—notably excluding the business income of pass-through entities—would result in a revenue change of approximately \$100 billion over 10 years.¹² Put another way, reducing the corporate rate as part of revenue-neutral tax reform requires roughly \$100 billion of base broadening for each point of rate reduction.

Considered in the context of a tax reform effort structurally similar to that undertaken in 1986, agreement on approximately \$1 trillion in base-broadening provisions within the current U.S. tax code would be needed in order to reduce the corporate tax rate to 25 percent—a rate that is still above the non-U.S. OECD average—on a revenue-neutral basis. Another option is to replace income tax revenue with consumption tax revenue, an issue discussed later in this report.

In examining this challenge, the working group reviewed the recent largest non-international corporate tax expenditures.¹³ These are set forth in Table 4 below.

Table 4: Select Corporate Tax Expenditures, 2014-2018

Corporate Tax Expenditure	Total Amount (Billions)
Deferral of gain on like-kind exchanges	68.0
Deduction for income attributable to domestic production activities	65.1
Exclusion of interest on public purpose State and local government bonds	49.2
Tax credit for low-income housing	38.8
Deferral of gain on non-dealer installment sales	34.0
Expensing of research and experimental expenditures	28.4
Reduced rates for first \$10,000,000 of corporate taxable income	20.4
Depreciation of equipment in excess of alternative depreciation system ¹⁴	-40.5

Source: Joint Committee on Taxation.

Along with major corporate tax expenditures, the working group examined major revenue-raising provisions in recent tax reform plans. The largest revenue-raising provisions for two of the most recent comprehensive tax reform plans—former Ways & Means Chairman Dave Camp’s Tax Reform Act of 2014 (the “Camp proposal”) and the Bipartisan Tax Fairness and Simplification Act of 2010, introduced by Senators Wyden and Gregg (the “Wyden-Gregg proposal”), which is similar to legislation later introduced by Wyden, Coats, and Begich (D-AK) (the “Wyden-Coats proposal”)—are set forth in Table 5 below.

Table 5: Top Domestic Base Broadeners, Select Tax Reform Plans

Top Domestic Tax Base Broadeners Tax Reform Act of 2014 Discussion Draft	Ten Year Estimate (Billions)
Depreciation changes	269.5
Amortize research and experimentation expenditures	192.6
Amortize advertising expenditures	169.0
Phase out section 199 manufacturing deduction	115.8
Repeal LIFO accounting	79.1
Limitation of net operating loss deduction	70.5

Top Domestic Tax Base Broadeners Bipartisan Tax Fairness and Simplification Act of 2010	Ten Year Estimate (Billions)
Depreciation changes	568.6
Reduction of corporate interest deduction by inflation factor	162.7
Termination of preferential treatment of income attributable to domestic production activities	154.3
Termination of preferential treatment of intangible drilling and development costs in the case of oil and gas wells and geothermal wells	6.8
Revaluation of LIFO inventories of large integrated oil companies	4.5
Repeal of lower-of-cost-or-market value of inventory rule	3.0

Source: Joint Committee on Taxation.

Among other provisions, the working group focused and engaged with stakeholders on significant revenue-raising provisions common to recent plans or that have been otherwise considered in the recent tax reform debate. These include, but are not limited to:

The repeal or modification of accelerated depreciation provisions. Cost recovery issues were a major focus of the working group, and the repeal of or modifications to the modified accelerated cost recovery system (“MACRS”) are common to several recent proposals.

The Wyden-Coats proposal, for instance, repeals MACRS and replaces it with the Alternative Depreciation System (“ADS”), a change estimated by JCT to raise \$586.6 billion over 10 years.¹⁵ The Camp proposal would replace MACRS with a system that is similar to ADS and would allow taxpayers to adjust their depreciable basis for inflation on depreciable personal property, changes estimated to raise \$269.5 billion over 10 years. Former Senate Finance Committee Chairman Baucus’s 2013 Staff Discussion Draft on Cost Recovery and Accounting (the “Baucus Cost Recovery proposal”) would repeal MACRS and ADS and replace both with a system of constant depreciation percentages and asset pools.

Capitalization and amortization of certain expenses. Several recent plans contain changes to certain current-law expensing provisions. For instance, both the Camp proposal and the Baucus Cost Recovery proposal repeal the expensing of R&E expenses and require these expenses to be capitalized and amortized ratably over five years. Under the Camp proposal, this change raised \$192.6 billion over 10 years.

Repeal or phase-out of the section 199 manufacturing deduction. Repeal or phase-out of all or part of the section 199 manufacturing deduction is another feature common to recent reform plans. The Camp proposal phases out the deduction, raising \$115.8 billion over 10 years. The Wyden-Coats proposal would repeal the deduction. President Obama’s FY 2016 budget proposal eliminates the domestic manufacturing deduction for oil, gas, and coal.

Reduction of the corporate interest deduction. Limiting the deductibility of corporate interest expenses has been raised as a possible base-broadening provision throughout the recent tax reform debate. The Wyden-Gregg proposal, for instance, reduces the corporate interest deduction by an inflation factor, raising \$162.7 billion over 10 years.

From the outset, the working group determined that its discussions would not narrowly focus on revenue effects, but also on policy outcomes.

For example, the working group considered how slowing depreciation deductions could affect investment, and the trade-offs between accelerated depreciation and lowering the corporate tax rate. Improvements outside of schedules and class lives that could be made to

the current-law depreciation system, discussed later in the report, were also a topic of conversation. With respect to the corporate interest deduction, relevant considerations include effects related to the financial sector as well as broader policy issues such as biases towards debt-financed investment and implications for the cost of capital. For instance, while some economists view reduction or elimination of the deduction for corporate interest as a mechanism to reduce the tax code bias in favor of debt, other economists – and many in the business community – have expressed the concern that restricting the ability to deduct interest expenses could raise the cost of capital and discourage investment.

And, in evaluating all of these potential changes, it is important to note that the provisions described above were included in comprehensive drafts that provided other tax benefits or changes for taxpayers.

Finally, the working group discussed three central policy issues when analyzing these and other potential base broadeners that could be used to lower the corporate tax rate.

First, the non-international business base-broadening options within the jurisdiction of the working group affect both pass-through businesses and corporations. Using these base-broadening provisions to lower the corporate tax rate only, without other changes, could disadvantage non-corporate businesses. This issue, along with other issues related to pass-through entities, is discussed in more detail later in the report.

Second, certain of the base-broadening options within the jurisdiction of the working group generate “one-time” revenue, or could be considered timing differences that increase revenues more initially than in the long run. There are concerns by some that these options, while raising revenue in the short term and in the budget window, may result in long-term revenue losses and increased deficits if used for permanent rate reduction or if relied on for funding other permanent tax reform changes.

Several of the top business tax base-broadeners employed by recent tax reform plans implicate at least one of these two issues. For instance, as mentioned briefly above, the various changes to accelerated depreciation that slow depreciation deductions have the effect of pushing the cost of the depreciation deductions outside the standard ten-year window. (Concerns with this issue may be exacerbated by the negative effect that slowing depreciation schedules may have on investment, discussed later in this report.) The repeal of the section 199 deduction, while representing a permanent revenue gain, affects a significant number of pass-through entities.¹⁶

The working group does not believe that the presence of either of these two issues automatically disqualify a provision from committee consideration. However, we do believe

that these two issues should be taken into account in any committee consideration of funding a reduction in the corporate tax rate with base broadening.

Finally, the evaluation of revenue effects depends on the baseline against which those effects are measured. A current-law baseline can produce much different results compared to a current-policy baseline, or a baseline that assumes certain tax preferences are permanent but not others. While there can be disagreement about which baseline is appropriate to use in the tax reform and in other contexts, a consistent baseline in tax reform is necessary to fully understand the trade-offs needed to undertake comprehensive tax reform.

As the tax reform discussion in Congress and the Finance Committee continues, the members of the working group would be pleased to build on the work that was done during the tax reform working group process and continue to engage with the committee on analyzing, on a bipartisan basis, potential options and recommendations related to base-broadening provisions.

2. The Challenge of Treating Pass-Through Businesses Equitably

Some have characterized business tax reform as “corporate tax reform,” but this is a misnomer. In fact, the vast majority of businesses in America are not C corporations, but rather are pass-through entities, such as partnerships, sole proprietorships, limited liability companies (“LLCs”), and S corporations. Other less common types of business form, such as Real Estate Investment Trusts (“REITs”) and Master Limited Partnerships (“MLPs”), are also often considered pass-through or “flow-through” enterprises. While various types of pass-through entities have different characteristics, they share one basic attribute: the fact that business income is not taxed at the entity level but rather is passed through to shareholders who are taxed at the individual tax rates.¹⁷

As noted earlier, there has been tremendous growth in the number of pass-through businesses in America in recent decades, especially since individual tax rates were lowered as part of the Tax Reform Act of 1986. Today pass-through businesses make up more than 90 percent of all businesses in America, employing 55 percent of the private sector workforce and earning more than 60 percent of all net business income.¹⁸ While not addressed in this report, non-tax factors also play a role in the decision to organize as a pass-through entity.

The large majority of these businesses are small businesses, although it should be noted that a small minority of pass-through businesses are in fact quite large and earn a significant share of all pass-through business income, as shown in the table below.

Table 6: Distribution of C and S Corporations and Partnerships by Receipts, 2012

Firms classified by receipts	C Corporations				S Corporations				Partnerships			
	Number of Returns	Receipts (Millions)	Cumulative Percent		Number of Returns	Receipts (Millions)	Cumulative Percent		Number of Returns	Receipts (Millions)	Cumulative Percent	
			Returns	Receipts			Returns	Receipts			Returns	Receipts
\$0 or less	209,901	-1,169	12.84%	-0.01%	563,894	-3,420	13.41%	-0.05%	2,143,161	0	63.25%	0.00%
\$1 to \$2,500	42,551	45	15.44%	-0.01%	96,155	102	15.70%	-0.05%	63,031	65	65.11%	0.00%
\$2,501 to \$5,000	23,201	86	16.86%	0.00%	54,793	199	17.00%	-0.05%	39,260	142	66.27%	0.00%
\$5,001 to \$10,000	41,376	299	19.39%	0.00%	80,031	576	18.90%	-0.04%	56,283	415	67.93%	0.01%
\$10,001 to \$25,000	94,136	1,594	25.14%	0.00%	202,996	3,431	23.73%	0.01%	130,944	2,205	71.79%	0.06%
\$25,001 to \$50,000	111,694	4,061	31.97%	0.02%	284,347	10,469	30.49%	0.18%	100,183	3,665	74.75%	0.14%
\$50,001 to \$100,000	140,882	10,310	40.59%	0.07%	415,507	30,363	40.37%	0.65%	141,807	10,212	78.93%	0.35%
\$100,001 to \$250,000	236,684	39,495	55.06%	0.25%	769,034	126,769	58.66%	2.61%	210,177	34,305	85.13%	1.07%
\$250,001 to \$500,000	185,414	66,890	66.40%	0.56%	569,970	205,296	72.21%	5.78%	140,004	50,915	89.27%	2.14%
\$500,001 to \$1,000,000	185,719	132,170	77.75%	1.17%	459,997	323,755	83.15%	10.79%	126,895	90,707	93.01%	4.04%
\$1,000,001 to \$10,000,000	294,274	886,398	95.75%	5.27%	616,617	1,710,611	97.81%	37.24%	198,992	584,107	98.88%	16.31%
\$10,000,001 to \$50,000,000	50,033	1,033,403	98.81%	10.04%	76,420	1,531,082	99.63%	60.92%	28,789	597,322	99.73%	28.84%
More than \$50,000,000	19,504	19,469,284	100.00%	100.00%	15,690	2,527,471	100.00%	100.00%	9,036	3,389,677	100.00%	100.00%
Total	1,635,369	21,642,866			4,205,452	6,466,705			3,388,561	4,763,737		

Source: Internal Revenue Service, Statistics of Income, published and unpublished data and Joint Committee staff calculations.

Unlike corporations, income of many pass-through entities is taxed at marginal rates lower than the top individual rate and the corporate rate (disregarding the additional tax levied on any distributions to shareholders). Table 7 shows partnership and S corporation income by adjusted gross income of the taxpayer (owner) for 2012. For 2012, the top individual income tax bracket applied to taxable income in excess of \$388,350. Adjusted gross income exceeds taxable income. Therefore, all individual taxpayers with adjusted gross income under \$250,000 have a marginal tax rate below the top rate (as would at least some taxpayers with adjusted gross income above this amount). This suggests that the tax rate that applied to more than 80 percent of returns with partnership or S corporation income was below the top marginal individual income tax rate, while the majority of adjusted gross income—88 percent—was taxed at the top marginal rate.

Table 7: All Individual Returns: Partnership and S Corporation Net Income Loss by Size of Adjusted Gross Income, Tax Year 2012

(All figures are estimates based on samples—money amounts are in thousands of dollars)

Size of adjusted gross income	Partnership and S corporation net income less loss			
	Number of returns	Amount	Cumulative Percent Returns	Amount
No adjusted gross income	419,815	-41,039,489	5.05%	-7.67%
\$1 under \$5,000	115,676	-342,490	6.45%	-7.73%
\$5,000 under \$10,000	155,836	115,648	8.32%	-7.71%
\$10,000 under \$15,000	182,639	319,100	10.52%	-7.65%
\$15,000 under \$20,000	197,155	598,575	12.90%	-7.54%
\$20,000 under \$25,000	228,305	1,186,185	15.64%	-7.32%
\$25,000 under \$30,000	203,439	985,960	18.09%	-7.14%
\$30,000 under \$40,000	419,602	2,169,523	23.14%	-6.73%
\$40,000 under \$50,000	405,242	2,329,108	28.02%	-6.29%
\$50,000 under \$75,000	983,647	10,396,112	39.87%	-4.35%
\$75,000 under \$100,000	895,706	11,187,044	50.65%	-2.26%
\$100,000 under \$200,000	2,068,239	52,626,169	75.55%	7.58%
\$200,000 under \$250,000	456,185	23,692,434	81.04%	12.00%
\$250,000 under \$500,000	875,617	84,806,847	91.58%	27.86%
\$500,000 under \$1,000,000	407,117	92,556,202	96.48%	45.16%
\$1,000,000 under \$1,500,000	116,852	49,870,902	97.89%	54.48%
\$1,500,000 under \$2,000,000	53,517	31,063,187	98.53%	60.28%
\$2,000,000 under \$5,000,000	83,463	82,221,052	99.54%	75.65%
\$5,000,000 under \$10,000,000	22,519	40,582,093	99.81%	83.24%
\$10,000,000 or more	15,823	89,682,702	100.00%	100.00%
All returns, total	8,306,398	535,006,863		

Note: Detail may not add to totals because of rounding.

Source: IRS, Statistics of Income Division, Publication 1304, July 2014, and JCT staff calculations.

Given these statistics, it is apparent that pass-through businesses play a critical role in our economy and in our communities. Clearly, business tax reform needs to ensure that these businesses are not ignored in an effort to reduce the corporate tax rate. While effective rate differentials may vary depending on various tax preferences and the frequency of corporate distributions, JCT staff estimated for the working group that a reduction of the corporate rate of seven percentage points or more could put pass-through businesses at a tax disadvantage relative to C corporations. Pass-through businesses need to benefit from business tax reform for any such effort to be considered a success.

The treatment of individual tax rates is outside the jurisdiction of the working group. However, it is worth noting that there is disagreement regarding how to deal with individual

tax rates. While many members of Congress have called for combining individual and business tax reform (sometimes referred to as “comprehensive tax reform”) in an effort that would cut tax rates for both individuals and businesses, other members of Congress and the Obama Administration have signaled they will not support lowering statutory individual tax rates, particularly the top rate, for a variety of reasons, including revenue loss concerns, or the need to address distribution issues before supporting a lower rate. Given this dynamic (including the need for the support of the administration for any tax reform effort to be signed into law), members of Congress of both viewpoints described above have been exploring options to address the concerns of pass-through businesses in an environment where lowering individual tax rates faces significant hurdles.

The challenge of benefiting pass-throughs without lowering individual tax rates is further complicated by the fact that nearly any serious base-broadening effort to allow for a reduction in the corporate tax rate would be likely to negatively impact pass-through businesses. This is due to the fact that most business credits and deductions that might be pared back or eliminated to finance corporate rate reduction are also used by pass-throughs. For example, according to JCT estimates shown on Table 8, 29 percent of the tax benefit of MACRS, 27 percent of the tax benefit of the section 199 deduction, and 31 percent of the tax benefits from like-kind exchange provisions accrue to individuals directly or through pass-throughs.

Table 8: Selected Tax Expenditures with Corporate Estimates of at least \$10 Billion, FY 2014-2018

[Billions of Dollars]

Function	Corporations					Individuals					Total Corporate	Total Individual	Total 2014-18
	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018			
Deferral of active income of controlled foreign corporations.....	83.4	82.1	82.7	84.5	85.3	---	---	---	---	---	418.0	---	418.0
Exclusion of interest on public purpose State and local government bonds.....	9.3	9.7	9.8	10.1	10.3	23.8	25.6	26.0	26.7	29.1	49.2	131.2	179.6
Exclusion of investment income on life insurance and annuity contracts.....	2.7	2.7	2.8	2.8	2.9	27.4	28.1	28.9	29.5	30.3	13.9	144.2	158.1
Deferral of gain on like-kind exchanges.....	11.7	13.6	13.8	14.2	14.7	5.2	6.1	6.2	6.4	6.7	68.0	30.6	98.6
Deduction for income attributable to domestic production activities.....	12.2	12.5	13.2	13.6	13.6	4.6	4.7	5.0	5.2	5.2	65.1	24.7	89.9
Deferral of gain on non-dealer installment sales	6.9	6.9	6.8	6.7	6.7	2.7	2.1	1.7	1.4	1.2	34.0	9.1	43.0
Credit for low-income housing	6.8	7.3	7.8	8.3	8.6	0.3	0.3	0.3	0.4	0.4	38.8	1.7	40.5
Expensing of research and experimental expenditures.....	4.6	5.0	5.8	6.4	6.6	0.1	0.1	0.1	0.1	0.1	28.4	0.5	28.9
Reduced rates on first \$10,000,000 of corporate taxable income.....	3.8	4.0	4.2	4.2	4.2	---	---	---	---	---	20.4	---	20.4
Special treatment of life insurance company reserves.....	2.7	2.9	3.2	3.3	3.3	---	---	---	---	---	15.4	---	15.4
Inventory property sales source rule exception.....	3.0	3.0	3.1	3.1	3.1	---	---	---	---	---	15.3	---	15.3
Credits for electricity production from renewable resources (section 45) Wind.....	1.1	2.3	2.9	3.3	3.4	0.1	0.1	0.2	0.2	0.2	13.0	0.8	13.8
Interest rate and discounting period assumptions for reserves of property and casualty insurance companies.....	2.1	2.3	2.6	2.6	2.6	---	---	---	---	---	12.2	---	12.2
Exemption of credit union income.....	2.1	2.2	2.4	2.5	2.7	---	---	---	---	---	11.9	---	11.9
MEMORANDUM													
Depreciation of equipment in excess of the alternative depreciation system [1].....	-23.7	-21.0	-5.2	6.3	14.8	-9.7	-8.6	-2.1	2.6	6.1	-28.8	-11.7	-40.5

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NOTE: Details may not add to totals due to rounding.

[1] Includes bonus depreciation and general acceleration under MACRS.

Some commentators have noted that a sufficiently low corporate tax rate could induce some pass-through businesses to convert to the corporate form, and that a robust base of small and medium-sized corporations could ensure that corporate rates, should they be reduced, stay low.¹⁹ However, pass-through business stakeholders have suggested that conversion is not a feasible alternative and is one that imposes significant costs.

To summarize, pass-through businesses fear that they could find themselves with the worst of both worlds: no rate reduction combined with higher effective tax rates from base-broadening efforts. This is a valid concern and one that any business tax reform effort needs to consider with the utmost seriousness. The working group considered the following options to ensure that pass-through businesses are treated equitably in business tax reform.

a. Business Equivalency Rate

One idea for providing tax relief to pass-through businesses is what has been referred to as a “business equivalency rate.” The basic concept of this approach is to tax all active business income, regardless of business form, at the same rate. The business equivalency rate approach is described by the firm Grant Thornton as such: *“The same rates should apply to all business income regardless of the form of the business. If individual and corporate rate equivalency is not possible, Grant Thornton believes an elective business equivalency rate on qualified active trade or business income would ensure that all business income, whether earned in a pass-through or in a traditional corporation, is taxed at an equivalent rate.”*²⁰

Under the Grant Thornton proposal, the rate applied to active pass-through business income would be set at the top corporate tax rate. Qualified income would include all ordinary trade or business income reported to an individual owner by a pass-through entity engaged in an active trade or business. Further, the active trade or business test would occur at the entity level and investment income unrelated to the trade or business of the company would not qualify.

The business equivalency rate approach raises a number of questions for policymakers. First, would de-coupling the pass-through business tax rate from the top individual tax rate lead to tax abuse whereby upper income taxpayers would find ways to convert otherwise non-qualifying income into active business income for purposes of qualifying for the lower rate? If so, would Congress be able to draft rules to prevent such abuse without adding unnecessarily burdensome complexity to the code?

Today the differential between the corporate rate and the top individual rate is 4.6 percent. However, a successful business tax reform effort could widen this differential to

10 to 15 percentage points, thus greatly increasing the incentive to re-characterize income. According to JCT, decreasing the top rate on pass-through business income from 39.6 percent to 38.6 percent would reduce revenue by \$40.4 billion over 10 years. It is logical to assume that significant “leakage” from individual income that is effectively re-characterized as active business income would expand the revenue loss associated with this tax regime.

Even assuming that taxpayers do not find ways to convert income to qualify under the business equivalency rate, a \$40 billion per point reduction in the rate applied to pass-through income implies a 10-point rate reduction revenue loss of at least \$400 billion. It would be difficult to achieve significant rate reduction in a revenue-neutral tax reform process without curtailing many of the most popular tax expenditures utilized by pass-through businesses, such as MACRS, section 179 expensing or cash accounting. This challenge of rate reduction is not unlike the challenge of lowering the corporate rate, as discussed earlier.

The business equivalency rate approach also raises the question of whether tax rates should be equivalent between pass-throughs and corporations only at the entity level, or after taking into account any second layer of tax paid by shareholders. While issues affecting the double-taxation of corporate income are examined later in the report, it is worth noting that a recent tax reform working paper released by Senators Marco Rubio (R-FL) and Mike Lee (R-UT) adopts an equivalency rate of 25 percent coupled with exempting dividend and capital gains income from taxation at the shareholder level, thus fully equalizing the tax rate applied to corporate and non-corporate business income. Similarly, former Ways and Means Chairman Dave Camp’s Tax Reform Act of 2014 proposed a top rate on pass-through manufacturing business income of 25 percent, identical to the proposed corporate tax rate, while providing shareholders a 40 percent deduction for dividends and capital gains.

Alternatively, the 2005 President’s Advisory Panel report (i.e. Mack-Breaux) recommended a Growth and Investment Tax Plan (“GIT”) that would tax all business income, regardless of business form, at 30 percent, but with shareholders subject to a flat 15 percent rate on dividends and capital gains income.

Finally, there are two options for designing how the business equivalency rate would be calculated. Under one option, qualified active trade or business income would be computed separately from other income and not included in the taxpayer’s adjusted gross income (“AGI”). Under the other approach, the taxpayer would include the income in AGI and subject it to an alternate rate when applying the rate schedule to taxable income, similar to the current treatment of capital gains income. Grant Thornton notes that

including qualified business income in AGI would effectively tax it at a higher rate than the top corporate rate to the extent it also limited or phased out another tax benefit.²¹

It should be noted that some have expressed concerns about de-coupling the individual tax rates from the rates on pass-through business income. This concern is based on the belief that corporate-only rate reduction could result in Congress never addressing the difficult task of individual tax reform. There is also a concern that de-coupling would potentially make it more likely that Congress would choose to raise individual tax rates in the future, in particular the top individual rate.

b. Targeted Tax Benefits Approach

Another approach suggested to benefit pass-through businesses as part of business tax reform is to provide pass-throughs with more generous tax preferences while leaving the tax rate unchanged. Under this approach, specific tax benefits would be enhanced in an effort to target tax relief to pass-throughs in the form of lower effective tax rates. This approach has been advocated by the Obama Administration, both in the “President’s Framework for Business Tax Reform” released in 2012 (the “President’s framework”) and in the Administration’s recent budget submissions to Congress. A version of this approach is also included in the Wyden-Coats proposal.

The President’s framework, for example, would make permanent section 179 small business expensing at \$1 million; allow cash accounting for businesses with up to \$10 million in gross receipts; permanently double the deduction for start-up business costs from \$5,000 to \$10,000; and expand the health insurance tax credit for small businesses created in the Affordable Care Act.²² The Obama Administration’s most recent budget submission included additional items, entitled “Simplification and Tax Relief for Small Businesses” as part of the budget’s business tax reform reserve.

Specifically, the cash accounting provision previously included in the President’s framework was expanded to apply to businesses with up to \$25 million in gross receipts (regardless of inventory). In addition, the administration included a proposal to make permanent the 100 percent exclusion on gains from the sale of qualified small business stock, and the administration increased its proposal relating to the deduction for start-up business costs from \$10,000 to \$20,000.

Similarly, the Wyden-Coats proposal would expand expensing for small businesses, but in a manner different than the President’s framework. The Wyden-Coats approach would allow full expensing of all investments made by small businesses with gross receipts of up to \$1 million. According to a summary of the plan, this would cover 95 percent of

small businesses. This unlimited expensing provision is in the context of lowering the corporate tax rate to 24 percent while keeping the top individual rate at 35 percent (the top individual rate at that time). Whereas the administration's section 179 expansion is estimated to reduce revenues by \$63.8 billion over 10 years, the Wyden-Coats expensing approach was estimated by JCT in 2010 to reduce revenues by \$35.8 billion over 10 years.

The shortcoming of the targeted tax benefits approach is that it is perhaps too targeted, leaving out certain small businesses. For example, a small services firm – organized as an LLC or S corporation – may not have considerable investments to offset income relative to a more capital-intensive firm, would already use cash accounting due to lack of inventory, and would otherwise not benefit from any of the administration's small business proposals. Yet this small business, which may have formed as a pass-through for non-tax reasons, might suddenly find itself at a competitive disadvantage with a similarly situated C corporation benefitting from a reformed lower corporate tax rate. This is just one example of the types of businesses unlikely to benefit from the targeted tax benefits approach.

On the other hand, if the intent is to provide relief to smaller pass-through businesses without benefiting larger pass-throughs (i.e. subjecting large pass-throughs to current tax treatment while reducing the corporate tax rate), then the targeted tax benefits approach offers one alternative. However, it would still suffer the defect of leaving out certain smaller pass-throughs, as described above.

Pages A-1 to A-9 of the addendum to this report, which was prepared with the assistance of JCT staff, include a technical explanation of the administration's proposal to provide targeted tax relief to small businesses as part of business tax reform, as well as descriptions of other recent section 179 and cash accounting reform proposals.

c. Flow-Through Business Deduction

Yet another approach to provide pass-through businesses with a lower effective tax rate in business tax reform is the idea of a new deduction applying only to active pass-through business income. This approach offers some appeal, in the sense that (at least theoretically) a deduction can be utilized to accomplish the same level of effective rate reduction accomplished by a lower tax rate.

In 2012, the House of Representatives passed by a vote of 235 to 173 H.R. 9, the "Small Business Tax Cut Act," a business deduction bill sponsored by former Congressman Eric Cantor (R-VA). In short, the Cantor bill would have created a 20 percent deduction

applied to active business income, with certain exclusions, for tax year 2012. While the Cantor bill applied to C-corporation qualified small businesses as well as pass-throughs, such an approach in business tax reform could be limited to pass-through businesses if coupled with a reduction of the corporate rate. The Cantor bill was estimated by JCT at the time to reduce revenues by \$45.9 billion over 10 years.²³

Similarly, in 2010 Senator John Thune introduced and offered an amendment on the Senate floor to the tax extenders bill that would have created a 20 percent deduction for small business income, among other provisions. The amendment did not receive a vote on its substance but was rejected on procedural grounds (motion to waive a Budget Act point of order) by a vote of 38 to 61. At the time the amendment was supported by the National Federation of Independent Business (NFIB).

There are a number of design questions regarding a pass-through business deduction. How broadly does the deduction apply? Are specific types of income excluded, and should the deduction be limited based on the business's size or available to all pass-throughs?

H.R. 9, for example, would have limited the 20 percent deduction to small businesses with fewer than 500 full-time employees in calendar year 2010 or 2011. The bill would have also limited the 20 percent deduction to 50 percent of the greater of W-2 wages paid by the taxpayer to non-owner employees, or the sum of W-2 wages paid by the taxpayer to employees who are non-owner family members of direct owners and employees who are 10 percent or less direct owners. In addition, the bill specifically carved out financial services income (defined as royalties, rents, dividends, interest, or annuities).

The design choices accompanying a flow-through deduction make it likely that such a deduction could increase tax code complexity for small business owners who must determine what type of income is eligible for the deduction. While a deduction could be structured without limitations and carve-outs, it is likely that limiters would be necessary to constrain the cost of the proposal (as evidenced by the JCT estimate of the Cantor bill), as well as to address concerns that could be raised as to which types of businesses might benefit from the new deduction.

For example, when H.R. 9 was considered by the House, Congressman Ted Deutch (D-FL) offered a motion to recommit the bill to committee with instructions to prevent the tax deduction from being used on income from "illegal activities," defined as "pornography," "discriminatory golf courses and clubs," "lobbying" and "business activities of persons in violation of the Iran Sanctions Act of 1996." The motion to recommit failed by a vote of 179 to 229.

Some in the pass-through business community have expressed the concern that a new pass-through deduction, even if well-structured upon enactment, would be too easy for Congress to limit in the future. In their view, a lower rate is the only way to make it as difficult as possible for Congress to trim back the benefits from tax reform in the future. However, while it may be true that Congress is less apt to change tax rates, changes to tax rates are enacted from time to time, as evidenced by recent changes to the tax code.

The flow-through business deduction does have the benefit of addressing the concerns by those who believe that de-coupling the flow-through business rates from the individual rates could lead to higher individual rates. Under this point of view, by keeping rates coupled together – but enacting effective tax rate relief through a deduction – Congress might be less likely to raise individual rates if it is perceived to be a tax increase on small businesses.

In short, the flow-through business deduction allows a flexible mechanism to lower effective tax rates for pass-through businesses, but likely at the cost of greater complexity and a revenue loss similar to pass-through statutory rate reduction.

Pages A-10 to A-21 of the addendum to this report include a technical explanation of H.R. 9 as adopted by the House in 2012.

d. Other suggestions

While not discussed by the working group members, stakeholders have suggested other approaches to provide relief to pass-throughs as part of business tax reform. These approaches include a new deduction based on a set amount of active business income for all pass-through businesses, regardless of size (for example, allowing a 20 percent deduction on the first \$2 million of active pass-through business income). They also include business tax reform that would repeal or limit tax expenditures only as they apply to C corporations, leaving tax preferences utilized by pass-throughs untouched. This approach would essentially create parallel systems in the tax code, one for pass-throughs and one for C-corporations, potentially further distorting business decisions based on tax considerations.

Members of the Business Income Tax Working Group were not able to resolve the treatment of pass-through businesses in business tax reform, one of the most vexing challenges in business tax reform, given the constraints the group faced. However, members of the group believe that any tax reform effort must fully take into account the concerns and opinions of America's pass-through businesses. Business Income Tax

Working Group members strongly urge the chairman and ranking member to examine the options above, in addition to any other approaches the committee may consider, to ensure that pass-through businesses are treated equitably, should the Finance Committee decide to move forward on business tax reform.

Structural Reforms: A Business Tax Code to Promote Tax Neutrality and Economic Growth

Throughout the working group’s deliberations, the group considered two major structural issues that implicate many of the principles outlined above. These issues, and the reforms that focus on them, involve significant biases created by the current tax code. While the working group does not endorse any specific proposal discussed below, the reforms in this section and the problems they aim to address warrant further consideration and debate by the committee.

1. Taxing Business Income Only Once

As this report previously discussed, our tax system promotes inefficiency by incentivizing businesses to make decisions based, sometimes heavily, on tax considerations. Economists believe that the ideal tax system should strive for the concept of “tax neutrality,” in which distortions caused by the tax code are minimized and decisions are made based on business or economic merits.

Throughout the working group process, the working group focused particularly on how the issue of tax neutrality arises in the area of business entity choice. Putting aside views on the current taxations of pass-through entities and corporations, our tax code in theory would be more efficient if all business income were taxed equally. Our current system of taxing corporations violates the “tax neutrality” concept by subjecting large amounts of corporate profits to a double tax, while most other forms of business or investment income are subject only to a single layer of tax.²⁴ This extra tax on corporate profits can distort the choice of business entity and lead to fewer capital investments, a bias towards debt financing, and a bias against dividend distributions.²⁵

The choices dictated by the double taxation of corporate profits are reflected in other entity classification policies lawmakers have adopted in the past. To strengthen small businesses, Subchapter S of the tax code allows business owners to enjoy the legal benefits of corporate status (e.g., limited liability and free transferability of shares) and single taxation at the ownership level, provided that certain conditions are met. To provide a tax-preferred method for average taxpayers to invest in a portfolio of real estate assets, the tax code allows REITs to avoid most or all of the corporate income tax so long as ownership structure, distribution, and other requirements are satisfied.

The economic case against double taxation is not a new one, and there has been much serious study on different ways to reduce or eliminate the extra layer of tax on corporate income, both at the entity and at the shareholder level. This report considers one of these options—partial corporate integration—and the benefits and trade-offs it presents.

Corporate integration options

As previously discussed, more uniform treatment of business income would correct many of the distortions and inefficiencies created by the current system. Specifically, eliminating the double taxation of corporate income would reduce or eliminate at least four distortions built into the current tax code: (1) the incentive to invest in non-corporate businesses rather than corporate businesses; (2) the incentive to finance corporations with debt rather than equity; (3) the incentive to retain rather than distribute earnings; and (4) the incentive to distribute earnings in a manner that avoids or significantly reduces the second layer of tax.²⁶

Under the current tax code, corporate income is sometimes taxed twice, sometimes taxed once, and sometimes not taxed at all. First, consider a dividend paid by a company to a taxable shareholder. The income of the corporation is taxed twice: at the corporate level and at the individual level. Second, consider a dividend paid by a corporation to a tax-exempt shareholder, such as a non-profit organization, pension plan or foreign shareholder. In this instance the income is taxed only once, at the corporate level (the foreign shareholder is subject to a withholding tax that, depending on the applicable tax treaty, could be reduced to zero). Finally, consider income paid by a corporation in the form of an interest payment to a bondholder that is a tax-exempt entity. In this scenario, the corporation gets an interest expense deduction and the tax-exempt entity does not pay any tax on the interest income. The income is never taxed.

Corporate integration with respect to dividends and capital gains would also help to correct the tax code's very large bias towards debt financing over equity financing. Consider that the marginal effective corporate tax rate on equity-financed investment is 37 percent while the marginal effective corporate tax rate on debt-financed investment is negative 60 percent.²⁷

Full (or complete) corporate integration would entail flowing all business profits through to shareholders, sometimes referred to as the shareholder allocation method, similar to the treatment of certain pass-through entities. However, in the context of a publicly traded company, this is not a feasible option. It would be difficult and cumbersome to determine the share of income attributable to each shareholder, some of whom may have held the shares for a few months or a few days or even a few hours. Instead, efforts at corporate integration have focused on partial integration, where undistributed income is still taxed at the corporate level but income distributed to shareholders is taxed only once.

Although the concept of taxing business income only once is a simple one, the proposed methods for doing so are anything but simple. In fact, various corporate integration options have attempted to confront the myriad challenges and complications that arise from moving

from a “classical” taxation system where corporate profits are taxed once at the corporate level and again at the shareholder level, to a system of only one layer of tax. The working group examined some of these options, as well as the approaches that other nations currently employ.

A desire to arrive at a tax system where business income is taxed once starts with the question of where to apply the tax.²⁸ Some proposals would apply tax at the corporate level but would exempt shareholders from taxation. One approach, known as the dividend exclusion method, was proposed by the Treasury Department in 1992 and by President George W. Bush in 2003. In fact, a version of the Bush proposal was scheduled for markup in the Finance Committee before being changed due to revenue concerns. A lower tax rate on qualified dividend and capital gains income was ultimately adopted as a result of this effort.

While the dividend exclusion method has the benefit of being simpler than some other corporate integration proposals, it suffers from two major shortcomings. First, it does not equalize the treatment of debt versus equity. Dividend payments still come out of income taxed at the corporate level while interest payments are deductible from income by the corporation. Second, the dividend exclusion method can result in no level of tax where the income earned by the corporation is exempt from tax, such as with interest from state and local bonds. Additionally, the dividend exclusion method only provides relief from double taxation with regard to distributed income. If a taxpayer experiences share price appreciation due to retained earnings, the shareholder will incur the second layer of tax in the form of capital gains from the sale of the stock. For this reason, most dividend exclusion proposals include a mechanism to increase the shareholders’ basis in their stock by the amount of retained earnings.

Some proposals have provided shareholders a credit for taxes paid by the corporation. This approach is utilized by certain countries, such as Australia, where shareholders claim a tax credit for the corporate-level tax paid on distributed amounts. Some have commented that because Australia allows no shareholder credits for foreign corporate taxes, Australian companies have considerably less incentive to shift corporate taxable income abroad than under current U.S. law.²⁹

Other approaches move the single level of tax on distributed corporate income to the shareholder, providing the corporation with a dividends paid deduction (DPD). As such, there is only one layer of tax on distributed corporate income (the DPD does not achieve integration with respect to retained earnings). In addition to eliminating part of the double taxation of corporate income, this approach has the benefit of treating dividends the same as

interest payments, thus removing the bias in the tax system towards debt financing over equity financing.

In 1984, as part of the Reagan Administration's Treasury I report, the Treasury Department proposed a DPD limited, based on revenue concerns, to 50 percent of dividends paid. In Treasury II, this proposal was scaled back even further, to a DPD limited to 10 percent of dividends paid. This proposal was adopted by the House of Representatives as part of the House tax reform bill in December of 1985. However, ultimately the DPD was not enacted as part of the Tax Reform Act of 1986.

Taxation at the individual level would also tend to promote progressivity with respect to owners of corporate stock. Consider that under the current system, a shareholder in a low tax bracket has his share of the corporate income taxed first at the 35 percent corporate rate. A system whereby corporate income distributed to the shareholder in the form of a dividend was not taxed at the corporate level but instead at the individual level would mean a tax system where the income was taxed at the shareholder's lower tax rate. At the same time, a high-income taxpayer would pay at the higher individual rate. To the extent that the top individual rate is higher than the corporate rate (as it is currently), moving to a system of taxing corporate income at the shareholder level would result in additional revenue generated, revenue that could help to pay for moving to the new system. Of course, this example assumes that under such an integrated structure, dividend income is taxed at ordinary income rates, rather than the current preferential rates. One recent paper on corporate integration concluded that *"locating the ultimate business tax at the shareholder level would be both more efficacious and more progressive than the current system."*³⁰

Taxation at the individual level could also have political advantages that make it easier to enact relative to the dividend exclusion approach. Without exploring these considerations in detail, it is worth noting that a proposal that would completely exempt high-income taxpayers from any tax on their investment income could be a difficult proposal to advance, especially at a time of increased focus on income inequality.

While the working group did not have official estimates from JCT as to the cost of various integration proposals, it is logical to assume that removing an existing layer of tax could lose significant revenue. In order to address this revenue concern, some have proposed that a DPD could be coupled with a withholding tax on dividends. The withholding tax would equal the top corporate tax rate and would be imposed on dividends paid by a domestic C corporation. At the shareholder level, dividends would be taxed at ordinary income rates with a non-refundable credit from the withholding tax.

In many respects a DPD coupled with a withholding tax is similar to an imputation credit approach, as suggested by the American Law Institute (ALI) in 1993, under which the shareholder would receive a credit for corporate taxes paid on distributed corporate income. However, the DPD approach has the added advantage that a corporation's cash flow is increased as a result of the deduction for dividends paid. This increased cash flow may lead the corporation to increase the amount of dividends it pays to shareholders.³¹ Additionally, the DPD may have the political benefit of gaining support from the business community relative to the imputation credit and other approaches imposing the tax at the corporate level.³²

Any corporate integration approach will need to address how two important groups of shareholders are treated: tax-exempt entities and foreign shareholders. Under a DPD, distributed corporate income would not be taxed at all if tax-exempt shareholder retained current law treatment. This would run counter to the goal of taxing business income once and could raise revenue concerns. Likewise, dividends to some foreign shareholders (those not subject to a withholding tax by virtue of a U.S. tax treaty) would also represent corporate income never taxed.

These concerns could be remedied by imposing a withholding tax on the dividends paid to tax-exempt shareholders. The withholding tax could serve as the final tax for these shareholders. However, this could prove problematic if tax-exempt shareholders, such as non-profits or retirement funds, viewed substituting a new withholding tax for the current corporate income tax on distributed earnings as a tax increase. The implications of applying a withholding tax on dividend income to retirement funds and non-profits must be very carefully considered. This would especially be the case if the DPD did not result in corporations increasing their dividends (thus offsetting to some extent the withholding tax). To equalize the treatment of debt versus equity, Congress would need to consider whether this regime should apply to interest payments as well.

The treatment of foreign shareholders under this approach also presents complications. Foreign shareholders are generally subject to a withholding tax of 30 percent on dividends from U.S. corporations. However, U.S. tax treaties often reduce this tax to 15, 5 or even zero percent. Pairing a new withholding tax on dividends (and possibly interest) paid to foreign shareholders with a DPD would raise the question of whether Congress wants to make a change to the tax laws that may be viewed, by some, as overriding existing U.S. tax treaties.³³

It is important to note the potential trade-off between corporate integration proposals – assuming some of these options lose revenue – and lowering the corporate tax rate in revenue-neutral business tax reform. Corporate capital can move easily from country to

country. For some businesses, a corporate rate cut may provide more of an incentive to locate or remain in the U.S. than some corporate integration proposals.³⁴ Of course, corporate integration *combined* with a lower corporate rate would further help eliminate the distortions described above, but may be difficult to achieve in a revenue-neutral way.³⁵

While the working group is not in a position to endorse any specific corporate integration proposal, we commend Chairman Hatch for his thoughtful exploration of this topic in the more than 100 pages devoted to it in the “Staff Report on Comprehensive Tax Reform for 2015 and Beyond” released in December of 2014. We urge the chairman and Ranking Member Wyden to continue to explore options for better integration of the corporate tax system with the individual tax system so as to lessen the double taxation of income and promote a more neutral tax system, with a particular focus on arriving at an approach that is administrable, easy for taxpayers to comply with, and achieved in a fiscally responsible manner.

Pages A-22 to A-31 of the addendum include a technical explanation of the corporate integration approach proposed by the Bush Administration in 2003.

2. Removing Disincentives to Save and Invest

In addition to the potential biases produced by the double taxation of corporate income, the working group also discussed another important and overarching concern—the bias in our income tax system that disfavors savings and investment. While the primary focus in recent debates on our domestic business income tax system have focused on structure and rates, this bias arises primarily from the U.S. income tax base.

As shown earlier in this report in Figure 2, income taxes are the primary source of U.S. tax revenue.³⁶ From an economic perspective, income taxation by its very nature creates a bias against savings (which are taxed), and thus towards current consumption. This bias against savings could affect investment and capital formation and, in turn, productivity and economic growth. Consumption taxes, on the other hand, exclude savings from the tax base. By removing the tax system from the decision on whether to save or consume, a consumption tax system does not discriminate between present consumption and savings. Changing the mix of taxes in the U.S. tax “pie” to more heavily favor a consumption tax base could counteract the disincentives to save and invest that exist under current law.

The benefits of moving towards a consumption tax base are not purely theoretical. For example, recent research on the tax systems of OECD nations indicate that consumption taxes are associated with greater growth of gross domestic product per capita compared to income taxes. In a study that examined over 30 years of data on 21 OECD countries,

consumption taxes were found to be more growth-friendly than both personal income taxes and corporate income taxes. Corporate income taxes, especially, appeared to have the most negative effect on GDP per capita.³⁷ This evidence suggests that growth-oriented tax reform should move away from an income tax base and towards a consumption tax base.

Because of the potential benefits of encouraging savings and investment and the implications for economic growth, the working group reviewed several recent comprehensive reform plans that move partially or completely towards a consumption tax base. These include, among other plans, the following:

The FAIR Tax Act of 2015. The FAIR Tax Act of 2015, sponsored by Senator Moran and supported by Senators Isakson and Roberts among others, replaces much of the existing U.S. tax system with a 23 percent, tax-inclusive retail sales tax on use or consumption in the U.S. of taxable property and services. The Act repeals the individual and corporate income tax, self-employment and payroll tax, and estate and gift tax. A family consumption allowance is provided to certain taxpayers based on poverty level and family size.

The Progressive Consumption Tax Act of 2014. The Progressive Consumption Tax Act of 2014, introduced by Senator Cardin in the 113th Congress, alters the composition of U.S. taxes by imposing a broad-based, credit-invoice value-added tax at a 10 percent rate. The corporate tax rate is lowered to 17 percent and the individual income tax code is simplified, with the top income tax rate reduced to 28 percent. To provide progressivity, the Act exempts the first \$100,000 of taxable income for joint filers (\$50,000 for single filers) and provides a rebate to low- and middle-income households based on income and family size. The Act is intended to be revenue neutral and result in tax rates on consumption, individual income, and corporate income below the OECD average. To alleviate concerns regarding the amount of taxes raised, the Act rebates excess consumption tax collected if revenues from the new consumption tax exceed 10 percent of gross domestic product for the calendar year.

Rubio-Lee Tax Plan. The Economic Growth and Family Fairness Tax Plan, a conceptual reform plan released by Senators Rubio and Lee in March 2015, contains several provisions that would shift the tax code in the direction of a consumption tax. On the business side, the plan imposes a top rate of 25 percent that would apply to all corporations and pass-through entities with income in excess of \$150,000. Businesses would be permitted to fully deduct the cost of all investment in the year that those investments are made. New business debt would not be tax deductible, but interest income would be exempt from tax. Individuals would be subject to two tax rates, 15 and 35 percent, and investment income from capital gains, dividends, and interest would be tax free.

Growth and Investment Tax Plan. President George W. Bush’s 2005 Advisory Panel on Federal Tax Reform recommended two major tax reform proposals. One of these proposals, the Growth and Investment Tax Plan (“GIT”), imposed a progressive tax structure on wage and compensation income and a flat, 15 percent rate on interest, dividends, and capital gains income. Businesses (other than sole proprietorships) would pay a single rate of 30 percent on their cash flow, defined as total sales minus purchases of goods and services from other businesses and wages and other compensation paid to employees. For the most part, businesses would not be entitled to deduct interest paid or include interest received.

While these plans involve different structural approaches, all contain elements that move the U.S. tax system towards a consumption-oriented base. The FAIR Tax Act, for instance, simply repeals all other taxes and imposes a retail sales tax directly on the consumer. The Progressive Consumption Tax Act adjusts the U.S. tax “pie” towards consumption taxes by imposing a credit-invoice value-added tax that taxes the difference between all sales and purchases, exempting a significant number of taxpayers from the individual income tax, and lowering the corporate and individual income tax rates. The cash-flow method employed by the GIT resembles a modified or hybrid subtraction method value-added tax, and the Rubio-Lee plan contains elements of both consumption and income taxation. In fact, in their purest forms, the structures adopted by all of these plans can result in an identical consumption base.³⁸

However, each consumption-oriented plan also reflects different policy choices on how exactly to achieve that base. To more fully evaluate the different plans, the working group discussed several of these issues, including the difference between types of consumption taxes; the consumption taxes used by other OECD countries; the need for transparency in imposing a consumption tax; concerns and solutions related to progressivity; the trade implications of adopting a consumption tax; transition issues; and design choices related to enforcement and administration.

Making a fundamental shift to consumption-oriented taxation is a major change that may not necessarily be undertaken in the near term. However, given the pro-growth effects of consumption taxes, the working group believes that the issues above and consumption-based tax systems in general deserve the attention of the committee as tax reform efforts continue.

Aside from examining more comprehensive tax plans that tackle the bias against savings and investment, the working group also spent a considerable amount of time examining cost recovery provisions, particularly for tangible assets, in the business income tax code. While some studies on individual provisions have presented mixed results, overall, the economic literature on tax policy and investment suggests that provisions like accelerated depreciation and expensing have a noticeable impact on investment.³⁹

As discussed above, slowing depreciation deductions has the potential, at least in the budget window, to raise revenue. For several recent tax reform plans, cost recovery is a major component of their attempts to lower corporate tax rates on a revenue-neutral basis.

At the same time, many economists have observed that changes in tax depreciation schedules could have serious effects on the overall level of investment in the U.S. economy. Lowering tax rates will, of course, lower the cost of capital, as taxpayers allocate less of their return on investment to covering their tax liabilities. However, lengthening depreciation schedules may counteract the beneficial effects of rate reduction, especially for capital-intensive businesses such as those in the manufacturing sector.

Thus, there are some concerns that offsetting reductions in the corporate tax rate by changing cost recovery allowances could have the net effect of decreasing investment and economic growth, depending on the policies adopted.⁴⁰ For example, according to JCT's analysis of the plan, the cumulative effects of the repeal of MACRS and certain amortization provisions in the Camp proposal outweigh the positive incentives from reduced rates over time.⁴¹ Given the uncertainty surrounding these trade-offs, the working group urges the committee to carefully consider the interaction of slowed depreciation and lowered tax rates when evaluating any comprehensive tax reform plan.

Outside of modifying the magnitude and timing of depreciation deductions, the working group also examined the complexity of current accelerated depreciation provisions. Since the 1986 Act, few significant revisions have been made to asset classifications or class lives under the MACRS rules. However, these rules have grown more complex as lawmakers have adopted special provisions for certain assets, various temporary incentives, and anti-abuse rules.⁴²

The Baucus Cost Recovery proposal, mentioned earlier in this report, represents a significant example of a recent reform that simplifies current-law cost-recovery rules. Among other provisions, the Baucus proposal employed a cost-recovery system for "pooled property" (generally, most tangible property and computer software). Under the proposal, pooled property is divided into four categories, and costs are recovered by multiplying the applicable recovery rate for each pool by the year-end pool balance. The pool balance each year is equal to the prior year's pool balance, increased by current-year additions to the pool, and decreased by current-year sales and other dispositions of pooled property.

By employing this streamlined pooling method, the Baucus proposal eliminates the need for tracking depreciation on individual assets and greatly simplifies depreciation calculations. While the working group does not endorse any particular position the Baucus proposal takes

on asset classifications or recovery rates, the pooling concept and its simplification benefits both deserve further committee focus.

Finally, cost recovery issues also implicate the corporate alternative minimum tax (“AMT”), which, for some businesses, can slow depreciation schedules. While there is evidence that the AMT has not been an effective mechanism for combating tax avoidance but has imposed considerable undesired costs on unsuspecting businesses, especially manufacturers, the working group did not come to a conclusion on corporate AMT modifications or repeal. However, the committee may want to further examine the effect of the corporate AMT on investment. Should repeal be considered by the committee, such consideration should include a discussion of fair transition rules that could allow businesses to take advantage of certain deferred tax assets accumulated under the current system. For example, there have been proposals to ensure that AMT credits (which represent a prepayment of taxes) can be utilized prior to tax reform to avoid complexities related to transition issues, such as legislation introduced by Senators Stabenow, Roberts, Brown (D-OH), and Blunt (R-MO) to raise the limitation on the amount of AMT credits that can be accelerated in lieu of bonus depreciation.

Pages A-32 to A-54 of the addendum to this report include a technical explanation of the cost recovery reforms included in the Baucus Cost Recovery proposal as well as the Camp proposal.

Promoting American Innovation

An important component of modernizing the tax code is ensuring that America's business tax system adequately incentivizes innovation, especially as innovation is viewed as increasingly important to economic growth and rising incomes in a competitive global economy. Many economists view technological innovation as accounting for a major share of long-term growth in real per-capital income in the U.S.⁴³ Further, innovation often leads to higher productivity, meaning increased wages for American workers and lower prices for goods tied to the technological innovations.

Economists also generally view private research activities as generating positive externalities, meaning that the benefits of the research are spread well beyond the business undertaking the research activities. In other words, the spillover benefits to society outweigh the benefits to a single business engaged in research activity. Some studies have found that the benefit to the economy of private-sector research is at least twice the estimated return to the company performing the research.⁴⁴ However, because firms are not able to capture all of the benefits of the research themselves, they tend to underinvest in these activities. In this sense, the external benefits of private innovation create a market failure and government intervention in the form of a tax benefit is justifiable.

The tax code currently attempts to foster innovation through generous treatment of research expenses. Specifically, the tax code allows qualified research expenses by businesses to be expensed, as well as provides a credit for research expenditures in the form of the R&E tax credit. The combined effect of these policies is to greatly lower the after-tax cost of research for profitable firms, thus encouraging these firms to conduct more research and development ("R&D") than they might otherwise. According to the Office of Management and Budget, in FY2012 the combined budgetary cost of these policies totaled \$11.1 billion, which was about 8 percent of the \$140.9 billion spent by federal agencies on defense and non-defense R&D that year.⁴⁵ Additionally, many states also offer research-related tax incentives.

While there are questions, discussed below, regarding the design of the R&E credit and the need for improvements, there is considerable evidence that the credit has the intended effect of incentivizing research and creating higher-wage jobs tied to this research. A 2011 study by Ernst & Young, prepared for the R&D Credit Coalition, found that the credit has increased annual private research spending by \$10 billion in the short term and by \$22 billion in the long term.⁴⁶ A study of the R&E credit from 1981 to 1991 found that roughly \$2 in research were generated for every one dollar in tax expenditure.⁴⁷

However, as other nations have increased the generosity of their research incentives, some have expressed the concern that existing incentives in the tax code are inadequate to the task of

promoting cutting-edge R&D and the associated high-wage jobs. These observers have suggested two major initiatives that could be adopted as part of business tax reform: a strengthened and permanent R&E credit and a patent/innovation box.

1. A Strengthened and Permanent Research Credit

Although the U.S. was the first nation to promote R&D through the tax code, with the enactment of the R&E credit in 1981, evidence suggests that the U.S. has fallen behind other nations in recent years. An OECD study in 2013 ranked the U.S. R&D tax policy as 22nd among nations.⁴⁸ In 2012, the Information Technology and Innovation Foundation (ITIF) estimated that the U.S. ranked 27th out of 42 countries examined in terms of the generosity of its R&D tax incentive, down from 23rd five years earlier.⁴⁹ To quote from the ITIF study: *“what was once the most generous R&D tax incentive in the world has now become one of the least generous.”*

Many of the nations with which the U.S. competes have taken the view that innovation is the key to competitive advantage in the global economy and, as such, have taken steps to boost their research incentives. While some of these nations are our European competitors (such as Spain, France and Norway), other nations that have improved their research incentives are up-and-coming developing nations. For example, India is generally considered to have one of the most generous incentives for R&D, offering a 200 percent “super deduction” for in-house R&D, a 125 percent to 200 percent deduction to contractors carrying out R&D in India, and a 100 percent deduction for R&D expenses that do not otherwise qualify for the other deductions. Similarly, Brazil offers a 160 percent super deduction for R&D expenditures, while China offers a 150 percent super deduction and immediate expensing for qualified R&D equipment. In its ranking of R&D incentives that placed the U.S. at #27, ITIF found that India, Brazil and China ranked #1, #7 and #16 (respectively).⁵⁰

If the U.S. is to strengthen the R&E credit to better compete with the incentives offered abroad, there are a number of design questions to be addressed. For example, what is the appropriate credit rate? Should the incentive require that IP be based in the U.S. (as some countries require) or is the requirement that the research be performed in the U.S. sufficient? Should the current haircut for contract research be eliminated or otherwise modified?⁵¹ Should the U.S. R&D incentive remain an incremental credit or should the U.S. consider the deduction approach employed by many of our competitors? Should the credit be made refundable or otherwise modified to provide a stronger benefit to start-up or small companies that may not yet be profitable?

Recent R&E credit reform proposals have addressed a number of these questions. In particular, R&E bills have proposed to raise the Alternative Simplified Credit (“ASC”) rate.⁵²

For example, former Chairman Camp's tax reform plan would have made the R&E credit permanent and raised the credit rate from 14 percent to 15 percent. The Obama Administration has proposed making the credit permanent and included a proposal in its most recent budget to raise the ASC rate to 18 percent. In 2011, Senators Baucus and Hatch introduced a bill in that would raise the ASC rate to 20% and make the credit permanent. Finally, earlier this year, the House passed H.R. 880, legislation to make the R&E credit permanent and raise the ASC rate from 14 percent to 20 percent. However, the Obama Administration issued a Statement of Administration Policy (SAP) indicating that the president would veto the House bill because the cost of the bill (\$181.6 billion according to JCT⁵³) was not offset.

Studies have indicated that a more generous research incentive, in the form of a higher ASC credit rate, would generate additional research in the U.S. In May of 2014, JCT evaluated an ASC rate of 20 percent and found that it could increase research spending by as much as 10 percent.⁵⁴ A 2011 Ernst & Young study found that a permanent R&D credit with an ASC rate of 20 percent would increase annual private research spending by \$15 billion in the short term and \$33 billion in the long-term, resulting in 130,000 additional research-related jobs in the short term and 300,000 such jobs in the long term.⁵⁵ Similarly, a 2010 ITIF study found that increasing the ASC rate from 14 to 20 percent would create 162,000 jobs, generate 3,850 new patents each year, increase productivity by 0.64 percent and GDP by \$66 billion per year, and that increased federal revenues would exceed the tax expenditure costs of the credit within 15 years.⁵⁶

Some R&E proposals in the context of tax reform would change the cost recovery treatment of research expenses in order to help offset the cost of improving the credit. Both the Camp proposal and the Baucus Cost Recovery proposal, while making the R&E credit more generous, would require that firms capitalize and amortize R&D expenses ratably over 5 years. The Camp proposal was scored by JCT as raising \$192.6 billion over 10 years,⁵⁷ and explained the change by noting that tangible and intangible property created through research and experimentation have a longer useful life than a single tax year. As with other cost recovery provisions, this consideration must be weighed against a potential decrease in investment. By one estimate the Camp approach would reduce R&D by as much as \$25 billion per year, which would reduce productivity growth by an estimated 0.18 percent per year.⁵⁸

In addition to requiring amortization of research expenses, the Camp proposal would have disallowed the credit for research expenses relating to software development. It is unclear why former Chairman Camp proposed this new restriction, unless this was a decision based not on encouraging U.S. research but rather based strictly on revenue concerns in the context of a revenue-neutral tax reform plan. Such a restriction on the credit does not appear in

keeping with efforts to advance U.S. innovation in as broad a range of technologies as possible. In fact, software development is a key component of U.S.-based research efforts. According to ITIF: “*When companies perform R&D it is not just to test a new material using a Bunsen burner – increasingly company R&D also involves software development. Indeed, software is at the core of many new technologies in many different industries, not just the software industry.*” ITIF notes that almost 20,000 companies took the R&E credit for developing software, while 13,000 took the credit for developing software that was embedded in other products. In total, U.S. companies spent \$76 billion on software for R&D purposes in 2011, which amounts to nearly one-third of the \$239 billion total corporate-funded domestic investment in R&D.⁵⁹

R&E proposals have also addressed the fact that the R&E credit currently reduces the tax benefit for firms that contract out their research expenses, limiting the credit to 65 percent of research spending. In general these proposals would reduce the “haircut” associated with contract research on the theory that when encouraging U.S. research the federal government shouldn’t preference one type of research (in-house) over another (contract). For example, the *Competitiveness and Opportunity by Modernizing and Permanently Extending the Tax Credit for Experimentation* (COMPETE Act) introduced by Senators Tom Carper (D-DE) and Pat Toomey (R-PA) would allow businesses conducting research on behalf of another business (i.e. contract research) to claim the 35 percent of the R&E credit that is effectively “lost” under the current credit. Senators Carper and Toomey believe this provision would be particularly beneficial in areas such as biotechnology and pharmaceuticals, where contract research is a common method of conducting business. A somewhat different approach to this issue is embodied in the Obama Administration’s R&E budget proposal, which would raise the amount of contract research expenses that could be claimed by the contracting firm from 65 percent to 75 percent but only for payments to qualified non-profit organizations.

Another area of interest is whether or not the existing R&E credit effectively encourages research at small- and medium-sized firms, especially newer firms that may not yet be profitable. These concerns may stem from the fact that the credit tends to be claimed disproportionately by larger businesses, the firms that tend to spend the most in dollar terms on research activities. According to JCT calculations based on IRS data as shown in Table 9 below, while C and S corporations with more than \$50 million in assets accounted for 18.3 percent of firms claiming the R&E credit, these firms accounted for 86.4 percent of total credits claimed.

Table 9: Percentage Distribution of Corporations (C and S) Claiming R&E Tax Credit and of Credit Claimed by Corporation Size, 2012

Asset Size (\$)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	1.8%	2.4%
1 thru 99,999	5.8%	(1)
100,000 thru 249,999	2.9%	0.1%
250,000 thru 499,999	4.8%	0.3%
500,000 thru 999,999	7.9%	0.6%
1,000,000 thru 9,999,999	38.0%	4.4%
10,000,000 thru 49,999,999	20.5%	5.8%
50,000,000 +	18.3%	86.4%

(1) Less than 0.1 percent.

Note: Sums may not add to 100 percent due to rounding.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Efforts to expand the use of the credit among small- and medium-sized firms has primarily focused on two approaches: ensuring that the individual AMT does not prevent owners of pass-through businesses from claiming the credit, and allowing a portion of the credit to be refundable.

For example, the *Innovators Job Creation Act of 2015* (S. 455) was introduced earlier this year by Senators Pat Roberts, Chris Coons (D-DE) and Chuck Schumer (D-NY). The legislation would allow small businesses to elect to apply up to \$250,000 of the research credit against their payroll tax liability, limited to small businesses with gross receipts of \$5 million or less and no gross receipts for any period before the five taxable year period ending with the taxable year. The legislation would also allow research credits to offset both regular and AMT liability. The bill tracks the Schumer/Roberts amendment that was adopted to the *Expiring Provisions Improvement Reform and Efficiency Act*, reported out by the Finance Committee in April of 2014.

Additionally, both the House-passed legislation and the Administration's FY 2016 budget proposal would allow the R&E credit to offset AMT liability. The Administration's budget would also repeal the requirement that R&E costs be amortized over 10 years when calculating individual AMT.

It is worth noting that a third approach geared towards making it easier for small firms to raise capital to fund research – although not limited to the R&E credit - is embodied in legislation introduced this Congress by Senators Carper and Toomey. The COMPETE Act would, among other provisions, modify the passive loss rules in the tax code to allow investors in a business to claim losses and R&E credits generated by the business, subject to a number of restrictions.⁶⁰ A similar provision was included in Senator Toomey’s legislation in the 114th Congress with Senators Menendez, Roberts and Carper, the *Start-Up Jobs and Innovation Act*, legislation that sought to make it easier for early-stage start-up companies engaged in ground-breaking research to attract capital. While efforts to lower the cost of capital related to research for small firms are commendable, the Finance Committee should carefully consider any modifications to the passive loss rules, which were enacted as part of the Tax Reform Act of 1986 to combat tax shelters prevalent at the time.

The working group encourages the committee to find ways to make the R&E credit more accessible to pass-through businesses and other small businesses when considering options for strengthening the R&E credit.

The R&E credit has been extended 16 times since it was first enacted in 1981, often on a retroactive basis after the credit had expired. In fact, the R&E credit is not currently in law, having expired at the end of last year. Yet it is likely that very few businesses that conduct R&D expect the credit will not be reinstated. To say that the R&E credit is a “temporary” provision of the tax code is to state something that may be technically accurate, but does not actually reflect reality.

Perhaps a simpler measure for improving the R&E credit is to make it permanent, something that could be accomplished within revenue-neutral business tax reform. Regardless of the design decisions Congress may make in reforming the credit, as discussed herein, a permanent rather than temporary credit would be a more effective mechanism to encourage research by allowing for the planning of business decisions more than one or two years at a time, as research projects often span longer periods of time.

It is interesting to note that the 2012 ITIF study attempted to quantify how much the U.S. would need to boost the ASC rate in order to match the tax incentives offered by other nations. According to this analysis, to reach the 15th most generous research tax incentive (offered by the Netherlands) the U.S. would need at least a 20 percent ASC rate. In order to reach the 10th most generous tax incentive (on par with Norway), the U.S. would need a 27 percent credit; to reach 5th place (equivalent to Denmark’s incentive) would require a 35 percent credit. In order for the U.S. to have the most generous R&D tax incentive in the world, surpassing India, the ASC rate would have to be increased from 14 percent to 50

percent. These figures demonstrate the lengths to which other nations have gone to capture increasingly mobile, cutting-edge research.⁶¹

The point is not that America needs the most generous research tax incentive in the world given the many other advantages that America possesses when it comes to attracting R&D. Rather, the point is that our nation cannot continue to fall further and further behind if we expect to continue to lead the world in innovation and creativity in the 21st century information economy. Combined with a lower corporate tax rate, a more robust incentive for R&D would solidify the U.S. as the undisputed premier location for business research. Business tax reform offers the opportunity to make a permanent, improved R&E credit a reality.

Pages A-55 to A-60 of the addendum to this report include a technical explanation of recent R&E credit reform proposals.

2. Innovation Box Regimes

In addition to improvements to the existing R&E credit, the working group also considered another domestic incentive for innovation: a patent or innovation box regime. Unlike the R&E credit, which focuses on expenditures for activities related to research and development of new technologies, innovation boxes offer reduced taxation of the income generated by IP. Over the past decade, many OECD countries have adopted variations of an innovation box regime.

Because of the prevalence of the innovation box regimes in other jurisdictions, the working group requested that JCT provide an overview of existing regimes. Features of those regimes are presented in the table below.

Table 10: “Patent Box” Regimes in Select Countries

Country, Year Effective	Qualified IP	Nexus Requirement	Benefits
Belgium 2007	Qualifying patents (excludes trademarks, designs, models, or secret recipes or processes)	Requires patent to be developed by Belgian company or acquired patent to be further improved by Belgian company	80 percent deduction of qualifying gross patent income
France 2000 (amended 2005 and 2010)	Patent granted in France, United Kingdom, or European Patent Office or specified European countries or if invention would have been patentable in France (excludes trademarks, design rights and copyrights)	Intellectual property rights must be owned by the French company, must own acquired rights for at least two years	Revenue or gain derived from the qualified property (does not include embedded royalties) taxed at 15 percent
Italy 2015	Patents and property functionally equivalent to patents	Follows OECD nexus approach.	Exemption for income sourced from intangible assets, 30 percent exemption in 2015, 40 percent exemption in 2016, 50 percent exemption after 2016
The Netherlands 2007	Worldwide patents and intellectual property arising from research and development activities for which the taxpayer has obtained a declaration from the Dutch government (trademarks, non-technical design rights and literary copyrights are excluded)	Dutch company must be the economic owner and bear the risks associated with ownership, development activities must be conducted at the risk of the Dutch company, but research and development is not required to be performed in the Netherlands	Five percent rate on income from a qualifying intangible, includes embedded royalties if more than 30 percent of the derived income is attributable to the patent
United Kingdom 2013	Patents granted by the United Kingdom or European Patent Office (excludes trademarks and registered designs) and certain associated intellectual property	Requires legal ownership of the patent, must be developed by a company in the worldwide corporate group, U.K. company must make a significant contribution to developing the patent	10 percent tax rate on income from patented inventions and certain other innovations

Source: Joint Committee on Taxation.

While the innovation box regime would be new to the U.S. tax code, the concept of providing tax preferences for certain types of income is not. For example, current section 199 could be described as a “domestic production box” that provides an enhanced deduction for income derived from certain activities.

Nonetheless, adopting a U.S. innovation box would necessarily present unique policy and administrative issues. The working group discussed, but did not come to conclusions on, several of these issues, including the types of IP that would qualify for the regime (for example, limiting the regime to patents, or expanding it to a broader range of IP such as trade secrets); whether development of the IP should be required to take place in the U.S. in order to qualify for preferential treatment (a “nexus” requirement adopted by several OECD countries that is meant to encourage further investment in domestic research and development); how the IP income would be taxed and which taxpayers would be eligible (including the challenge of identifying qualifying income, an active audit issue with respect to the current R&E credit); and what types of IP income would receive preferential treatment.⁶²

A primary question related to this last issue that the working group discussed is whether a U.S. innovation box regime should include income from foreign exploitation of IP. EU countries cannot limit their innovation box regimes to income from domestic exploitation due to EU treaty obligations. However, the U.S. could design an innovation box that requires domestic exploitation, much like current section 199 requires domestic production.⁶³

Though the working group focused more on the policy than the revenue effects of the provisions it discussed, the ultimate answers to all of these questions would affect the cost of any innovation box proposal. Concerns have been raised by some that, given the lack of conclusive studies on the economic effects of patent boxes and the complexity that an innovation box would add to the tax code, the cost of an innovation box—depending on its design—may outweigh the economic benefits the regime provides.⁶⁴ Others argue that because the U.S. faces intense competition for IP-based, higher-wage businesses and jobs, tax incentives that promote the development of innovative industries, both by encouraging domestic research and development activities and spurring commercialization of research outcomes, are particularly important.⁶⁵

An innovation box regime should not be considered a replacement for tax reform that lowers rates for business income. At the same time, IP income is highly mobile, and despite the non-tax advantages the U.S. presents, it may be difficult to retain an attractive environment for the creation and commercialization of IP as other OECD countries move to effective rates of as low as 5 to 15 percent for qualified IP income.

Given these challenges, the committee may want to consider a targeted regime paired with international reform, bearing in mind the questions above and the trade-offs between targeted incentives and broader business tax reform.

3. Promoting American Energy Independence

Energy incentives have been present in the U.S. income tax code almost since its inception, and many of these provisions fall within the jurisdiction of the working group. These provisions affect fossil fuels, renewable sources of energy, conservation and efficiency, and nuclear power, providing different levels and types of subsidies to a wide range of energy sources and technologies.

All told, there are over 40 different energy-related provisions in the tax code today, including those that recently expired. In general, these provisions fall into one of two categories: provisions that allow energy companies to recover the costs of their investments sooner than companies in other sectors of the economy, and tax credits that give a preference to specific types of energy sources or production facilities. Members of the working group differed on

whether the federal government should continue to favor certain types of energy sources or production over others or whether the government should create a neutral tax system for all types of energy, regardless of source or production.

Working group members who did not foreclose the possibility of a continued role for the tax code in the energy sector considered two broad principles where potential bipartisan consensus could emerge.

First, over half of the approximately 40 energy incentives in the tax code mentioned above are temporary, and tend to expire every year or two. These one- and two-year stop gaps, which are sometimes enacted by Congress retroactively, provide little certainty. As a result, taxpayers may choose to forgo the investments these provisions are meant to encourage. The impact of this uncertainty is sometimes exacerbated by the fact that project development timelines span multiple years, during which tax incentives may expire and then be reinstated after protracted legislative wrangling. Regardless of source or technology, energy tax policies – like tax policies generally – should be stable and predictable.

Second, and again regardless of source or technology, energy tax incentives, when appropriate, can and should be aimed at providing targeted and efficient incentives to overcome market failures. By the same token, incentives should be in place long enough to be effective, but must be carefully evaluated by Congress and phased out in a fair and predictable way as the goals of those incentives are reached or as industries and technologies mature.⁶⁶ Energy incentives can have a place in the tax code, so long as they encourage the development of truly innovative technologies that promote American energy independence.

In addition to these general principles, the working group considered several provisions or issue areas in the energy tax reform space. While the principles above should be kept in mind when evaluating these provisions, each warrants additional consideration and analysis by the committee.

Extension of Master Limited Partnership Treatment to Renewable Energy. Master Limited Partnerships (“MLPs”) are a form of publicly-traded partnerships.⁶⁷ Like all publicly traded partnerships, to qualify as an MLP, a partnership must receive at least 90 percent of its gross income from certain qualifying sources. The MLP structure, under which business income is only taxed once, is currently available to and used extensively by the non-renewable energy sector, and its use has contributed significantly to the growth of that sector’s infrastructure.

However, the qualifying sources of income currently do not include income from renewable sources. As with non-renewable energy sources, MLP treatment could prove very beneficial to private investment in renewable energy projects. In the 113th Congress, the extension of

MLP treatment to renewable energy attracted bipartisan support in the form of S. 795, the Master Limited Partnerships Parity Act, cosponsored by Senators Coons, Moran (R-KS), Stabenow, Murkowski (R-AK), and Landrieu (D-LA). A technical explanation of this proposal is included on pages A-61 to A-62 of the addendum to this report. In 2013, JCT estimated that S. 795 would cost \$307 million over five years, and \$1.3 billion over 10 years. The bill was reintroduced on June 24, 2015 by Senator Coons, and cosponsored by Senators Moran, Murkowski, Stabenow, Collins (R-ME), Bennet (D-CO), Gardner (R-CO), and King (I-ME).

Provisions that encourage energy efficiency, regardless of source. Encouraging energy efficiency—that is, reducing the amount of energy that is needed to provide products or services—is, by some measures, the cheapest method of providing U.S. households and businesses with electricity. The Department of Energy calculated that the United States wastes over half of the energy we produce, and some studies suggest that energy efficiency improvements could result in trillions of dollars in savings.⁶⁸ Technology-neutral incentives for innovative improvements in energy efficiency could help realize these savings, create jobs relating to the construction and implementation of these improvements, and increase energy affordability and security.

Provisions that encourage efficient storage and transmission, regardless of source. Finally, a second and important general area of energy tax policy that warrants further committee consideration is the efficient storage and transmission of energy. Regardless of energy source or the technology employed, encouraging efficient and effective storage and transmission of power can help control electricity costs, bringing more affordable and stable power to a greater number of households and businesses. As with energy efficiency technologies, truly innovative technologies in the transmission and storage arena can also make the U.S. energy system more reliable and enhance energy security.

While the working group focused on the three areas mentioned above – the R&E credit, innovation box incentives and energy provisions – in the context of promoting American innovation, this is not an exhaustive list, as there are additional areas ripe for consideration. The working group urges the committee to explore any and all options for removing barriers to American innovation that may exist in the tax code during business tax reform. For example, some technology companies have cited the section 382 net operating loss restrictions as inadvertently capturing firms that rely on successive rounds of venture capital funding. Other small businesses have raised the need to address AMT limitations and exclude IP valuations from the section 1202 qualified small business stock exclusion to make it more useful. Business tax reform offers an opportunity for updating business tax provisions to ensure that they are consistent with modern business models and practices, so

as to more effectively encourage innovation in an increasingly fast-paced and dynamic global economy.

Removing Complexity and Improving the Taxpayer Experience

Focusing on the major policy and structural changes that our business income tax system needs is clearly worthwhile. However, in recent tax reform debates, it is sometimes easy to lose sight of the biggest issues facing business owners and workers: complexity and compliance. The National Taxpayer Advocate has repeatedly raised the complexity of the tax code as a serious problem facing taxpayers, who spend billions of hours complying with tax filing requirements each year.⁶⁹ A significant majority of these taxpayers, including small business owners, must also turn to paid return preparers for assistance, spending billions of dollars on attorneys, accountants, and enrolled agents.

Administrative reforms, simplification measures, and other smaller changes may reduce noncompliance, improve taxpayer interactions with the IRS, and increase the time and money that businesses and organizations can spend on more productive purposes.⁷⁰ In addition, these small changes usually do not engender the controversy and questions that more comprehensive changes tend to inspire.

While the working group did not undertake an exhaustive overview of the many simplification and small improvement opportunities in business income tax law, these opportunities are, in general, worthy of the committee's attention. Provisions that may warrant further committee review include the following:

Rationalizing filing deadlines. Under current law, tax returns for calendar year corporations, including S corporations, are due on March 15 (September 15 if an extension is filed). Calendar year partnership and individual returns are due on April 15 (October 15 if an extension is filed). Individuals and corporations often rely on tax return information provided by partnerships to complete their returns. In addition, earlier receipt of forms such as W-2s could prove critical in detecting and preventing taxpayer identity theft.⁷¹ Modifying certain filing deadlines so that taxpayers will receive the information they need on a timely basis is a relatively straightforward, bipartisan administrative change that has been proposed multiple times, including in S. 420, the Tax Return Due Date Simplification and Modernization Act of 2013, sponsored by Senator Enzi; the Camp proposal; the President's FY 2016 budget; and former Senate Finance Committee Chairman Baucus's Tax Administration Discussion Draft.

A technical explanation of the Enzi proposal is included on pages A-63 to A-67 of the addendum to this report.

Electronic filing of Form 990s. Current law requires very large charitable organizations (those that file at least 250 returns during the calendar year) and very small organizations (those with gross receipts of less than \$50,000 annually) to file a Form 990 electronically. The majority of

non-profits still file paper returns. As a result, the IRS makes many Form 990s available to the public by providing scanned images of them in Tagged Image File format via DVDs. This manual conversion process is inefficient, expensive, and delays access to information. In order to increase transparency and accuracy, and reduce fraud, the committee should examine proposals that require all non-profits to file their Form 990s electronically. This proposal appears in the Camp proposal, the Baucus Tax Administration proposal, and in the Obama Administration's FY 2016 budget. According to JCT estimates of the Camp proposal, mandatory electronic filing of Form 990s for exempt organizations would have no revenue effect.

Pages A-68 to A-70 of the addendum to this report include a technical explanation of this proposal.

Expanded declaratory relief for 501(c) entities. Under current law, organizations applying for 501(c)(3) status may seek declaratory relief if their application is denied or if IRS fails to act on the application. If the IRS fails to act, the organization must first exhaust its administrative remedies and may not seek declaratory relief prior to 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination. The *Taxpayer Bill of Rights Enhancement Act* (S. 1578), introduced recently by Senators Grassley and Thune and supported by Senator Isakson, would extend these procedures to other 501(c) and 501(d) organizations, including 501(c)(4) social welfare organizations. This provision was also introduced as a separate bill, the *ACCESS Act of 2014* (S. 2708), by Senator Coats in the 113th Congress.

Pages A-71 to A-73 of the addendum to this report include a technical explanation of this proposal.

Private foundation excise tax simplification. Under current law, private foundations are required to pay a two percent excise tax on investment income. The excise tax rate is reduced to one percent in any year in which the foundation's distributions for charitable purposes exceeds the average level of the foundation's charitable distributions over the preceding five tax years. Private foundations devote considerable resources each year to determining whether they should calculate a one or two percent excise tax. Further, any increase in the foundation's payout in a given year (e.g., a response to increased needs or crises) makes it more difficult for the foundation to qualify for the reduced one percent excise tax rate in subsequent years. Simplification of the excise tax—for example, by utilizing a flat percentage—would provide administrative relief to foundations without undermining the original intent of the excise tax. A simplification proposal passed the House in February 2015 as part of the *America Gives Mores Act* (H.R. 644).

Pages A-74 to A-75 of the addendum to this report include a technical explanation of this proposal.

Enhanced deduction for food inventory donations. The enhanced deduction for donations of food allows individuals and organizations to reduce their taxable income by providing qualifying food inventory to certain charitable organizations. The provision is part of a package of 55 temporary tax extenders that were reinstated retroactively for the 2014 tax year, but expired again on January 1, 2015. The uncertainty caused by a need for an annual extension diminishes the incentive effect of this provision and reduces charitable giving. A version of this proposal passed the House in February 2015 as part of the *America Gives More Act* (H.R. 644) and Senator Patrick Leahy (D-VT) introduced a standalone bill in the Senate (S. 930) in April 2015. In addition to making the enhanced deduction for food inventory donations permanent, H.R. 644 expanded the provision, including increasing the maximum percentage deductible from 10 percent of total business income to 15 percent.

Disaster relief proposals. When natural disasters occur, lawmakers often enact emergency tax provisions to encourage charitable contributions, provide relief for individual taxpayers, and aid businesses in affected areas. Unfortunately, the type of relief and the response time by Congress often vary, resulting in taxpayers receiving different treatment for similar losses, and creating uncertainty until legislation is passed. Permanent disaster relief tax provisions that take effect when a disaster occurs would encourage certainty, fairness, and the prompt delivery of help to taxpayers in dire need. Among other proposals, the committee could consider providing permanent tax relief to businesses and households that is triggered for taxpayers residing in or with a principal place of business located in a federal disaster area.⁷²

¹ WHITE HOUSE & DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM (2012) [hereinafter PRESIDENT'S FRAMEWORK], <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf>.

² DONALD BRUCE, TAMI GURLEY-CALVEZ & MATTHEW MURRAY, NAT'L ASS'N OF MFRS., A MISSED OPPORTUNITY: THE ECONOMIC COST OF PRO-GROWTH TAX REFORM (2015), <http://www.nam.org/Data-and-Reports/Reports/A-Missed-Opportunity/A-Missed-Opportunity--The-Economic-Cost-of-Delaying-Pro-Growth-Tax-Reform-Full-Study.pdf>.

³ *Id.* at 12-14.

⁴ CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: 2015 TO 2025* 133 (2015), <http://www.cbo.gov/publication/49892>.

⁵ William C. Randolph, *International Burdens of the Corporate Income Tax* (Cong. Budget Office, Working Paper No. 2006-09, 2006), available at <https://www.cbo.gov/sites/default/files/2006-09.pdf> (“Given those values, domestic [U.S.] labor bears slightly more than 70 percent of the burden of the corporate income tax.”).

⁶ See Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimate and Analysis*, 66 NAT’L TAX J. 185 (Mar. 2013) (comparing estimates from four major studies, including Randolph, *supra* note 5).

⁷ KPMG Corporate Tax Rates Table, <http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx> (last visited June 26, 2015).

⁸ This report focuses on the top statutory corporate tax rate and average unweighted statutory rates. Estimates regarding the average effective corporate tax rate can vary over time, industries, and according to other factors like country size. See, e.g., Martin A. Sullivan, *Untangling Corporate Effective Tax Rates*, 146 TAX NOTES 1299 (2015).

⁹ The RATE Coalition is one example of a group that has agreed to make these trade-offs.

¹⁰ Note, however, the U.S. delivers a larger amount of government-provided goods and services via tax expenditures in the tax code than most OECD countries. With tax expenditures so accounted, the size of the tax pie in the United States is closer to its OECD competitors.

¹¹ Payroll taxes, which are paid by both the employer and the employee, represent a compelling one-third of total federal revenues today and 5.7% of GDP according to the most recent CBO 2015 Long-Term Outlook (June). Currently 80% of total federal revenues come from individuals, including owners of pass-through entities, and payroll taxes.

¹² Note that the Joint Committee staff estimate in Table 3 relates to a one percentage point *increase*, rather than a decrease, the statutory corporate income tax rates. This report uses this estimate as a proxy for a one percent decrease. The working group confirmed with JCT that the use of the estimate for this purpose is appropriate.

¹³ Potential base-broadening provisions that affect individuals were out of the jurisdiction of the working group and thus were not considered in the working group’s discussions and are not considered in this report.

¹⁴ This estimate includes bonus depreciation and general acceleration under MACRS. Bonus depreciation provides a larger deduction in the year in which equipment is placed in service. Depreciation deductions are smaller than they otherwise would be in subsequent years. The negative estimate reflects the fact that the effects of this reversal due to bonus depreciation in

prior years are larger than the effects of general acceleration under MACRS for fiscal years 2014 to 2018.

¹⁵ The revenue estimates presented in Table 5 and throughout this report are not necessarily comparable across proposals. The estimates use different baselines and in some cases involve different interactions with other provisions unique to a given proposal.

¹⁶ A table on how select tax expenditures impact corporations and individuals is included on page 25 of this report.

¹⁷ Unlike partnerships, entities like REITs are formed as corporations and are subject to special distribution rules. For instance, a REIT is required to distribute 90 percent of its income in the form of shareholder dividends. Thus, although the mechanism for getting to a single layer of taxation is different than partnerships, the result—taxation only at the ownership level—is the same.

¹⁸ KYLE POMERLEAU, TAX FOUND., AN OVERVIEW OF PASS-THROUGH BUSINESSES IN THE UNITED STATES (2015), *available at* <http://taxfoundation.org/article/overview-pass-through-businesses-united-states>.

¹⁹ Edward D. Kleinbard, *Take the Odds on Corporate Tax Reform*, BLOOMBERG VIEW (Mar. 3, 2015), <http://www.bloombergvew.com/articles/2015-03-03/corporate-tax-reform-looks-like-it-has-a-chance-in-2015>.

²⁰ PUB. POLICY & GOV'T AFFAIRS, GRANT THORNTON, BUSINESS EQUIVALENCY RATE: FAIRNESS FOR PASS-THROUGH BUSINESSES (2013).

²¹ *Id.*

²² PRESIDENT'S FRAMEWORK, *supra* note 1.

²³ STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., DESCRIPTION OF H.R. 9, THE "SMALL BUSINESS TAX CUT ACT" 14 (JCX-30-14, Mar. 26, 2012).

²⁴ Though this report focuses on the economic case against the corporate income tax, it is important to note that tax neutrality and the reduction of economic distortions are not the only considerations involved in this issue. For example, commentators have argued that the corporate tax is an important vehicle to regulate corporate behavior—a view that may not be inconsistent with the original intent behind the tax's adoption. *See* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004) (reviewing the traditional defenses of the corporate income tax and detailing the regulation argument).

²⁵ For a concise overview of these issues, see MARTIN A. SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY ch. 3 (2011).

²⁶ REPUBLICAN STAFF OF S. COMM. ON FINANCE, 113TH CONG., COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND (2014) [hereinafter COMPREHENSIVE TAX REFORM].

²⁷ *Id.* at 153 (citing Jason Furman, *Business Tax Reform and Economic Growth*, 145 TAX NOTES 121, 126 (2014)).

²⁸ In the view of the Finance Committee Republican staff draft pamphlet on tax reform, “[i]t makes no sense today to have two levels of taxation of corporate earnings. The difficult decision is not whether business income should be subject to more than one level of tax – it should not – but whether the business income should be taxed at the entity level or at the owner level.” *Id.* at 128.

²⁹ Michael J. Graetz & Alvin C. Warren, Jr., *Unlocking Business Tax Reform*, 145 TAX NOTES 707 (2014).

³⁰ *Id.* at 710.

³¹ COMPREHENSIVE TAX REFORM, *supra* note 26.

³² Part of the attractiveness of the DPD coupled with a withholding tax from the standpoint of corporations is that such an approach could have the effect of increasing the corporation’s earnings per share by reducing its tax expense for financial accounting purposes, depending on how the Financial Accounting Standards Board (FASB) treats the withholding tax.

³³ COMPREHENSIVE TAX REFORM, *supra* note 26.

³⁴ MARTIN A. SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY ch. 4 (2011) (noting that dividend relief to shareholders may be less beneficial than a corporate rate reduction and that recently countries who have adopted integration proposals have begun questioning that approach). Note that while a dividends-paid deduction proposal does provide an effective corporate rate reduction via that deduction, the magnitude of that effective rate cut would depend on a company’s dividend payout choices.

³⁵ Graetz & Warren, *supra* note 29.

³⁶ Certain areas of the U.S. tax code already contain consumption tax elements. For example, tax-preferred retirement plans defer tax on new savings, but require tax to be paid upon withdrawal for consumption.

³⁷ See Jens Arnold et al., *Tax Policy For Economic Recovery and Growth*, 121 ECON. J. F59 (2011); Åsa Johansson et al., *Tax and Economic Growth* (Org. for Econ. Cooperation & Dev. [OECD], Econ. Dep’t Working Paper No. 620, 2008), available at <http://www.oecd.org/tax/tax-policy/41000592.pdf>.

³⁸ For a brief overview, see David R. Burton, *Four Conservative Tax Plans with Equivalent Economic Results* (Heritage Found., Backgrounder No. 2978, 2014), available at <http://www.heritage.org/research/reports/2014/12/four-conservative-tax-plans-with-equivalent-economic-results>.

³⁹ STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., BACKGROUND AND PRESENT LAW RELATING TO MANUFACTURING ACTIVITIES WITHIN THE UNITED STATES 85 (JCX-61-12, Jul. 17, 2012).

⁴⁰ *Id.* at 75.

⁴¹ STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., MACROECONOMIC ANALYSIS OF THE “TAX REFORM ACT OF 2014” 15 (JCX-22-14, Feb. 26, 2014).

⁴² See, e.g., S. COMM. ON FINANCE, 113TH CONG., SUMMARY OF STAFF DISCUSSION DRAFT: COST RECOVERY AND ACCOUNTING (2013), available at <http://www.finance.senate.gov/imo/media/doc/Chairman's%20Staff%20Discussion%20Draft%20on%20Cost%20Recovery%20and%20Accounting%20Summary.pdf> (providing a short legislative history on cost recovery provisions).

⁴³ CONG. RESEARCH SERV., RL31181, RESEARCH TAX CREDIT: CURRENT LAW AND POLICY ISSUES FOR THE 114TH CONGRESS (2015).

⁴⁴ LUKE A. STEWART ET AL., INFO. TECH. & INNOVATION FOUND. [ITIF], WE’RE #27!: THE UNITED STATES LAGS FAR BEHIND IN R&D TAX INCENTIVE GENEROSITY (2012).

⁴⁵ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, FISCAL YEAR 2014 374 (2013).

⁴⁶ DR. ROBERT CARROLL ET AL., ERNST & YOUNG, THE R&D CREDIT: AN EFFECTIVE POLICY FOR PROMOTING RESEARCH SPENDING (2011), available at http://investinamericasfuture.org/PDFs/EY_R&D_Credit_Report_2011_09_16.pdf.

⁴⁷ Bronwyn Hall & John Van Reenan, *How Effective Are Fiscal Incentives for R&D? A Review of the Evidence*, 29 RES. POL’Y 449 (2000).

⁴⁸ OECD, OECD SCIENCE, TECHNOLOGY AND INDUSTRY 2013 SCOREBOARD (2013), http://dx.doi.org/10.1787/sti_scoreboard-2013-en.

⁴⁹ STEWART ET AL., *supra* note 44.

⁵⁰ *Id.*

⁵¹ Under the R&E credit, firms contracting out their research are able to claim 65 percent of any amount paid or incurred to a third party for qualified research..

⁵² The R&E credit allows companies to choose to calculate the credit either under the “traditional” credit, which is a 20 percent credit based on a firm’s ratio of qualified research expenses (QREs) to gross receipts from 1984 to 1998, or under the Alternative Simplified Credit method based on 14 percent of a taxpayer’s QREs in the current tax year above 50 percent of its average QREs during the previous three tax years.

⁵³ STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., ESTIMATED REVENUE EFFECTS OF H.R. 880, THE “AMERICAN RESEARCH AND COMPETITIVENESS ACT OF 2015,” SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON MAY 20, 2015 (JCX 86-15, May 20, 2015).

⁵⁴ STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., MACROECONOMIC ANALYSIS FOR AMERICAN RESEARCH AND COMPETITIVENESS ACT OF 2014 11 (May 2, 2014) (in the Committee Report to accompany H.R. 4438, available at <https://www.congress.gov/113/crpt/hrpt431/CRPT-113hrpt431.pdf>).

⁵⁵ CARROLL ET AL., *supra* note 46.

⁵⁶ ROBERT D. ATKINSON, ITIF, CREATE JOBS BY EXPANDING THE R&D TAX CREDIT (2010).

⁵⁷ See Table 5 for this revenue estimate.

⁵⁸ BEN MILLER ET AL., ITIF, WHY THE TAX REFORM ACT OF 2014 SHOULD EXPAND, NOT CUT, THE R&D TAX CREDIT (2014).

⁵⁹ *Id.* at 3.

⁶⁰ Among other anti-abuse provisions, the bill would restrict passive investors to active losses only to the extent related to contributions to fund R&D.

⁶¹ STEWART ET AL., *supra* note 44.

⁶² For a recent discussion of these and other issues related to adopting a U.S. innovation box regime, see Peter R. Merrill et al., *Is It Time for the United States to Consider the Patent Box?*, 134 TAX NOTES 1665 (2012).

⁶³ Former Ways & Means Chairman Chairman Dave Camp’s 2011 international discussion draft proposal represents another example of an innovation box type of structure. One of the base erosion options in that proposal, Option C, would tax all CFC income attributable to the exploitation of intangibles related to sales and services for customers outside the United States immediately, but at a reduced rate of 15 percent. However, any such income earned in a jurisdiction at a rate below 13.5 percent would be taxed at the full corporate income tax rate (25

percent).

⁶⁴ For an overview of the economic rationales behind innovation box regimes and a brief review of these studies, see STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND SELECTED POLICY ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME (JCX-51-15, Mar. 16, 2015).

⁶⁵ See, e.g., ROBERT D. ATKINSON & SCOTT ANDES, ITIF, PATENT BOXES: INNOVATION IN TAX POLICY AND TAX POLICY FOR INNOVATION (2011).

⁶⁶ The committee has several significant examples of goals and phase-outs it may consider should energy tax reform be taken up. These include, among others, Senator Carper's *Incentivizing Offshore Wind Power Act*, which ties its tax incentive to power generation, combined with a limited time period for installing facilities and the disallowances of additional, potentially duplicative incentives and Former Chairman Baucus's Energy Tax Reform Draft, which phases out technology-neutral credits based on certain clean electricity and clean fuel market measures. An additional approach is represented by the five-year wind production tax credit phase-out offered to the EXPIRE Act by Senator Thune.

⁶⁷ While the term "master limited partnership" and "publicly traded partnership" are often used interchangeably, "master limited partnership" is generally used to refer to publicly traded partnerships and limited liability corporations that operate active businesses that are primarily energy related. See NAT'L ASS'N OF PUBLICLY TRADED P'SHIPS, MASTER LIMITED PARTNERSHIPS 101: UNDERSTANDING MLPs (2013).

⁶⁸ See MCKINSEY & CO., ENERGY EFFICIENCY: A COMPELLING GLOBAL RESOURCE (2010).

⁶⁹ See, e.g., 1 TAXPAYER ADVOCATE SERV., 2012 ANNUAL REPORT TO CONGRESS (2012).

⁷⁰ Some commentators have noted that focusing on efficiency and simplification would be a beneficial and bipartisan way to reframe the tax reform debate. See GENE STEUERLE, ONE AVENUE TO BIPARTISAN TAX REFORM: SIMPLIFICATION AND IMPROVED TAX ADMINISTRATION (Apr. 8, 2014), <http://taxvox.taxpolicycenter.org/2015/04/08/one-avenue-to-bipartisan-tax-reform-simplification-and-improved-tax-administration/>.

⁷¹ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-14-633, IDENTITY THEFT: ADDITIONAL ACTIONS COULD HELP IRS COMBAT THE LARGE, EVOLVING THREAT OF REFUND FRAUD (2014), <http://www.gao.gov/products/GAO-14-633>.

⁷² For a thoughtful example of such reforms, see AM. INST. OF CPAS, NATURAL DISASTERS: THE CASE FOR PERMANENT TAX RELIEF (2015), available at <http://www.aicpa.org/advocacy/tax/downloadabledocuments/automatic-tax-relief-for-natural-disaster-victims-brochure.pdf> (detailing the need for and specific proposals regarding permanent disaster tax relief provisions).

APPENDIX

A. Election to Expense Certain Depreciable Business Assets

Present Law

A taxpayer may elect under section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation. For taxable years beginning in 2014, the maximum amount a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.¹ The \$500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000.² The \$500,000 and \$2,000,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.³ Qualifying property excludes investments in air conditioning and heating units.⁴ For taxable years beginning before 2015, qualifying property also includes off-the-shelf computer software and qualified real property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).⁵ Of the \$500,000 expense amount available under section 179, the maximum amount available with respect to qualified real property is \$250,000 for each taxable year.⁶

For taxable years beginning in 2015 and thereafter, a taxpayer may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property (not including off-the-shelf computer software, qualified real property, or air conditioning and heating units) that is purchased for use in the active conduct of a trade or business.

¹ For the years 2003 through 2006, the relevant dollar amount is \$100,000 (indexed for inflation); in 2007, the dollar limitation is \$125,000; for the 2008 and 2009 years, the relevant dollar amount is \$250,000; and for the years 2010 through 2013, the relevant dollar limitation is \$500,000. Sec. 179(b)(1).

² For the years 2003 through 2006, the relevant dollar amount is \$400,000 (indexed for inflation); in 2007, the dollar limitation is \$500,000; for the 2008 and 2009 years, the relevant dollar amount is \$800,000; and for the years 2010 through 2013, the relevant dollar limitation is \$2,000,000. Sec. 179(b)(2).

³ Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F. For sport utility vehicles above the 6,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is \$25,000. Sec. 179(b)(5).

⁴ Sec. 179(d)(1) flush language.

⁵ Sec. 179(d)(1)(A)(ii) and (f).

⁶ Sec. 179(f)(3).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision).⁷ Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However, amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property.⁸ Thus, if a taxpayer's section 179 deduction for 2013 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2014. Any such carryover amounts that are not used in 2014 are treated as property placed in service in 2014 for purposes of computing depreciation. That is, the unused carryover amount from 2013 is considered placed in service on the first day of the 2014 taxable year.⁹

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.¹⁰ If a corporation makes an election under section 179 to deduct expenditures, the full amount of the deduction does not reduce earnings and profits. Rather, the expenditures that are deducted reduce corporate earnings and profits ratably over a five-year period.¹¹

An expensing election is made under rules prescribed by the Secretary.¹² In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under section 179 may be revoked by the taxpayer without consent of the Commissioner for taxable years beginning after 2002 and before 2015.¹³

⁷ Sec. 179(b)(3).

⁸ Section 179(f)(4) details the special rules that apply to disallowed amounts with respect to qualified real property.

⁹ For example, assume that during 2013, a company's only asset purchases are section 179-eligible equipment costing \$100,000 and qualifying leasehold improvements costing \$200,000. Assume the company has no other asset purchases during 2013, and has a taxable income limitation of \$150,000. The maximum section 179 deduction the company can claim for 2013 is \$150,000, which is allocated pro rata between the properties, such that the carryover to 2014 is allocated \$100,000 to the qualified leasehold improvements and \$50,000 to the equipment.

Assume further that in 2014, the company had no asset purchases and had no taxable income. The \$100,000 carryover from 2013 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2014 taxable year under section 179(f)(4)(C). The \$50,000 carryover allocated to equipment is carried over to 2014 under section 179(b)(3)(B).

¹⁰ Sec. 179(d)(9).

¹¹ Sec. 312(k)(3)(B).

¹² Sec. 179(c)(1).

¹³ Sec. 179(c)(2).

Description of Options

Small Business Expensing Act of 2015¹⁴

This option provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2014, is \$1,000,000 of the cost of qualifying property placed in service for the taxable year. The \$1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,500,000.

In addition, the option makes permanent the treatment of off-the-shelf computer software as qualifying property. The option also makes permanent the treatment of qualified real property as eligible section 179 property and removes the limitation related to the amount of section 179 property that may be attributable to qualified real property for taxable years beginning after 2014.

The option also makes permanent the permission granted to a taxpayer to revoke without the consent of the Commissioner any election, and any specification contained therein, made under section 179.

The option applies to taxable years beginning after December 31, 2014.

America's Small Business Tax Relief Act of 2014¹⁵

This option provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2014, is \$500,000 of the cost of qualifying property placed in service for the taxable year. The \$500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000. The \$500,000 and \$2,000,000 amounts are indexed for inflation for taxable years beginning after 2015.

In addition, the option makes permanent the treatment of off-the-shelf computer software as qualifying property. The option also makes permanent the treatment of qualified real property as eligible section 179 property and removes the limitation related to the amount of section 179 property that may be attributable to qualified real property for taxable years beginning after 2014. Further, the option strikes the flush language in section 179(d)(1) that excludes air conditioning and heating units from the definition of qualifying property.

The option also makes permanent the permission granted to a taxpayer to revoke without the consent of the Commissioner any election, and any specification contained therein, made under section 179.

¹⁴ S. 1399 (114th Cong.), introduced May 20, 2015, by Sen. Michael Bennet.

¹⁵ H.R. 636 (114th Cong.), introduced February 2, 2015, by Rep. Patrick Tiberi; passed House February 13, 2015. See also, H.R. Rep. No. 114-21.

The option exempts any budgetary effects from the PAYGO scorecards under the Statutory Pay-As-You-Go Act of 2010.

The option applies to taxable years beginning after December 31, 2014.

President's fiscal year 2016 budget proposal¹⁶

This option extends the 2014 section 179 limitations for qualifying property placed in service in taxable years beginning after 2014, and provides that the maximum amount a taxpayer may expense is \$1,000,000 for qualifying property placed in service in taxable years beginning after 2015. The \$1,000,000 is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the year exceeds \$2,000,000. The amounts are indexed for inflation for all taxable years beginning after 2016, as is the dollar limitation on the expensing of sport utility vehicles.

In addition, the option makes permanent the treatment of off-the-shelf computer software as qualifying property.

The option also makes permanent the permission granted to a taxpayer to revoke without the consent of the Commissioner any election, and any specification contained therein, made under section 179.

The option applies to qualifying property placed in service in taxable years beginning after December 31, 2014.

¹⁶ As submitted to the Congress on February 2, 2015. See Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2016: Analytical Perspectives (H. Doc. 114-3, Vol. III), February 2, 2015, pp. 149-204.

B. Limitation on Use of Cash Method of Accounting

Present Law

Taxpayers using the cash receipts and disbursements method of accounting (the “cash method”) generally recognize items of income when actually or constructively received and items of expense when paid. Taxpayers using an accrual method of accounting generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.¹⁷ Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.¹⁸ An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.¹⁹

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method of accounting. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed \$5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the “gross receipts test”). The cash method of accounting may not be used by any tax shelter. In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.²⁰ Such taxpayers generally are required to keep inventories and use an accrual method of accounting with respect to inventory items.²¹

A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees.²² Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.²³

¹⁷ See, e.g., sec. 451.

¹⁸ See, e.g., sec. 461.

¹⁹ See, e.g., sec.166.

²⁰ Treas. Reg. secs. 1.446-1(c)(2) and 1.471-1.

²¹ Sec. 471; *Ibid.*

²² Sec. 448(d)(1).

²³ However, section 447 generally requires a farming C corporation (and any farming partnership if a corporation is a partner in such partnership) to use an accrual method of accounting. Section 447 does not apply to nursery or sod farms, to the raising or harvesting of trees (other than fruit and nut trees), nor to farming C corporations meeting a gross receipts test with a \$1 million threshold. For family farm C corporations, the threshold under the gross receipts test is \$25 million. For farmers, nurserymen, and florists not required by section 447 to capitalize preproductive period expenses, section 352 of the Revenue Act of 1978 (Pub. L. No. 95-600) provides that such taxpayers are not required to inventory growing crops.

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

Accrual method taxpayers are not required to include in income that portion of any amounts to be received for the performance of services in the fields of health, law, engineering, architecture, accounting actuarial science, performing arts, or consulting, that, on the basis of experience, will not be collected (the “nonaccrual experience method”).²⁴ The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Description of Options

The Senate Committee on Finance Chairman’s Staff Discussion Draft To Reform Certain Business Options - Limitation on Use of Cash Method of Accounting²⁵

This option both expands and restricts the universe of taxpayers that may use the cash method of accounting.

Under the option, the cash method of accounting may only be used by taxpayers that satisfy the gross receipts test, other than tax shelters. In the case of a partnership, S corporation, trust, estate, or other passthrough entity, the gross receipts test applies at the entity level as well as the partner, shareholder, beneficiary, or similar level. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed the applicable dollar amount of \$10 million for the three prior taxable-year period to use the cash receipts and disbursements method. This applicable dollar amount is adjusted for inflation in taxable years beginning after 2015.

The option eliminates the exceptions for farming businesses²⁶ and qualified personal service corporations. Thus, farming businesses and personal service corporations generally are precluded from using the cash method unless such farming business or personal service corporation satisfies the gross receipts test.

In the case of any taxpayer required by the option to change its method of accounting for any taxable year, such change is treated as initiated by the taxpayer and made with the consent of the Secretary. If a taxpayer is required to change its method of accounting for any taxable year

²⁴ Sec. 448(d)(5).

²⁵ MCG13833, available at <http://www.finance.senate.gov/newsroom/chairman/release/index.cfm>: “Baucus Works to Overhaul Outdated Tax Code,” November 21, 2013. See also, Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman’s Staff Discussion Draft to Reform Certain Business Options* (JCX-19-13), November 21, 2013.

²⁶ As a conforming amendment, the option also repeals the exception from the requirement to inventory growing crops provided in section 352 of the Revenue Act of 1978 (Pub. L. No. 95-600).

from the cash method because the taxpayer did not meet the gross receipts test, the taxpayer may not elect to change its method back to the cash method for any of the four taxable years immediately following the taxable year for which such change was first required.

The option exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the gross receipts test and that properly elect to use the cash method are not required to keep inventories.²⁷

Under the option, the rules for the nonaccrual experience method are retained and are moved from section 448 to new subsection (j) of section 451.

The option applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

Tax Reform Act of 2014 - Limitation on Use of Cash Method of Accounting²⁸

This option both expands and restricts the universe of taxpayers that may use the cash method of accounting.

Under the option, the cash method of accounting may only be used by natural persons (*i.e.*, sole proprietors) and taxpayers other than tax shelters that satisfy the gross receipts test. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed \$10 million for the three prior taxable-year period to use the cash receipts and disbursements method, so long as use of such method clearly reflects income.²⁹

The option eliminates the exceptions for qualified personal service corporations. Thus, personal service corporations generally are precluded from using the cash method unless such personal service corporation satisfies the gross receipts test. However, the option retains the exception for farming business such that farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.

Under the option, the rules for the nonaccrual experience method are retained and are moved from section 448 to new subsection (j) under section 451.

In the case of any taxpayer required by this section to change its method of accounting for any taxable year, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

²⁷ Thus, such taxpayers will not be required to use an accrual method by reason of Treas. Reg. sec. 1.446-1(c)(2).

²⁸ H.R. 1 (113th Cong.), introduced December 10, 2014, by then-Chairman of the Ways and Means Committee Dave Camp.

²⁹ Consistent with present law, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.

The option applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. Any resulting increase in income is taken into account over four taxable years beginning with the earlier of the taxpayer's elected taxable year³⁰ or the taxpayer's first taxable year beginning after December 31, 2018, using the following schedule: (1) first taxable year in such period, 10 percent; (2) second such taxable year, 15 percent; (3) third such taxable year, 25 percent; and (4) fourth such taxable year, 50 percent. For taxpayers with a final taxable year beginning before December 31, 2018, the present-law operative rules of section 481 apply (*e.g.*, the full amount of the section 481 adjustment required to be included under this option is included with the final return).

President's fiscal year 2016 budget proposal³¹

The President's fiscal year 2016 budget proposal to expand simplified accounting for small business and establish a uniform definition of small business for accounting methods includes an option that expands the universe of taxpayers that may use the cash method of accounting. Under this option, the cash method of accounting may be used by taxpayers other than tax shelters that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed \$25 million for the three prior taxable-year period to use the cash receipts and disbursements method. The amount is indexed for inflation for taxable years beginning after 2016.

The option retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the gross receipts test, so long as the use of such method clearly reflects income.³² However, the option eliminates the exceptions from the required use of the accrual method for farming corporations such that farming corporations will be precluded from using the cash method unless they meet the \$25 million gross receipts test.

Under the option, a taxpayer who fails the \$25 million gross receipts test would not be eligible for the exception from the accrual method for the current taxable year and subsequent four taxable years.

The option is effective for taxable years beginning after December 31, 2015.

³⁰ "Elected taxable year" means such taxable year as the taxpayer may elect (as prescribed by the Secretary) which begins after December 31, 2014, and is before the taxpayer's second taxable year beginning after December 31, 2018.

³¹ As submitted to the Congress on February 2, 2015. See Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2016: Analytical Perspectives (H. Doc. 114-3, Vol. III), February 2, 2015, pp. 149-204.

³² Consistent with present law, the cash method generally may not be used by taxpayers who do not meet the gross receipts test if the purchase, production, or sale of merchandise is an income-producing factor.

C. Passthrough Entity Business Deduction

Present Law

C corporations

A C corporation³³ is subject to Federal income tax as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends³⁴ to its shareholders. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed directly through to shareholders.

Tax rates for C corporations

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to \$50,000) to 35 percent (for taxable income over \$10,000,000); the intermediate rates are 25 percent (for taxable income above \$50,000 but not exceeding \$75,000) and 34 percent (for taxable income above \$75,000 but not exceeding \$10,000,000).³⁵ The benefit of graduated rates below 34 percent is phased out for C corporations with taxable income between \$100,000 and \$335,000, and the benefit of the 34 percent rate is phased out for C corporations with taxable income in excess of \$15,000,000. C corporation long-term capital gains are taxed at the same rates as C corporation ordinary income. Thus, the maximum tax rate for C corporation net long-term capital gains is 35 percent.

A C corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the C corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income ("AMTI") in excess of a \$40,000 exemption amount.³⁶ Certain credits that are allowed to offset a C corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a C corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years to the extent the regular tax exceeds the tentative minimum tax. Small C corporations meeting a gross receipts test are exempt from the corporate alternative minimum tax. Generally, a C corporation meets the gross receipts test if its average annual gross receipts for the prior three taxable years do not exceed \$7.5 million.

³³ A C corporation is so named because its Federal tax treatment is governed by subchapter C of the Internal Revenue Code of 1986, as amended (the "Code").

³⁴ Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates. Sec. 301(c).

³⁵ Sec. 11.

³⁶ Sec. 56(d)(2). The exemption amount is phased out for corporations with income above certain thresholds.

Passthrough entities

S corporations

An S corporation³⁷ generally is not subject to corporate tax on its income.³⁸ Instead, S corporation shareholders include in income their pro rata shares of the S corporation's items of income (including tax-exempt income), gain, loss, deduction, credit, and nonseparately computed income or loss, whether or not distributed.³⁹ To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.⁴⁰ Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.⁴¹

Partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the entity level.⁴² Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).⁴³ A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.⁴⁴ To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year.

Tax rates for individuals

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of up to \$9,225 for single filers and up to \$18,450 for married taxpayers filing joint returns or surviving spouses) to 39.6 percent (for taxable income over \$413,200 for single filers and \$464,850 for married taxpayers filing joint returns) for taxable year 2015; the intermediate rates are 15 percent, 25 percent, 28 percent, 33 percent, and

³⁷ An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

³⁸ Sec. 1363.

³⁹ Sec. 1366.

⁴⁰ Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

⁴¹ Sec. 1362.

⁴² Sec. 701.

⁴³ Sec. 702(a).

⁴⁴ Sec. 704(d).

35 percent⁴⁵ for 2015 (other than collectibles or unrecaptured section 1250 property). The maximum tax rate on net long-term capital gains generally is 20 percent.⁴⁶ Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains.⁴⁷

An alternative minimum tax is imposed on an individual in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the AMTI as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2015 are: (1) \$83,400 in the case of married individuals filing a joint return and surviving spouses; (2) \$53,600 in the case of other unmarried individuals; and (3) \$41,700 in the case of married individuals filing separate returns. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns. These amounts are not indexed for inflation.

Section 199 deduction

In general

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.⁴⁸ The deduction is equal to nine percent of the lesser of income from manufacturing, construction, and certain other activities specified in the statute (collectively, qualified production activities income), or taxable

⁴⁵ Secs. 1(a), (c) and (i).

⁴⁶ Sec. 1(h).

⁴⁷ Sec. 1(h)(11).

⁴⁸ Sec. 199.

income.⁴⁹ Thus, generally the maximum tax rate for a C corporation on its domestic production activities income is effectively 31.85 percent.⁵⁰

However, a taxpayer's deduction under section 199 for a taxable year may not exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.⁵¹

Qualified production activities income

In general, qualified production activities income is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;⁵² (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.⁵³

⁴⁹ However, for taxpayers that have qualified income related to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (collectively, "oil related production activities income"), the deduction is limited to six percent of its oil related production activities income. Sec. 199(d)(9).

⁵⁰ In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer and the deduction is allocated among such members in proportion to each member's respective amount (if any) of qualified production activities income. Members of an expanded affiliated group for purposes of the provision generally include those corporations which would be members of an affiliated group if such membership were determined based on an ownership threshold of "more than 50 percent" rather than "at least 80 percent."

⁵¹ For purposes of the provision, wages include the sum of the amounts of wages as defined in section 3401(a) (*i.e.*, wages subject to income tax withholding) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

⁵² For purposes of determining such costs, any item or service that is imported into the United States without an arm's length transfer price is treated as acquired by purchase, and its cost shall be treated as not less than its value when it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. With regard to property previously exported by the taxpayer for further manufacture, the increase in cost or adjusted basis may not exceed the difference between the value of the property when exported and the value of the property when re-imported into the United States after further manufacture. Except as provided by the Secretary, the value of property for this purpose is its customs value (as defined in section 1059A(b)(1)).

⁵³ See Treas. Reg. secs. 1.199-1 through 1.199-9 prescribing rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income. Where appropriate, such rules are similar to and consistent with relevant present-law rules (*e.g.*, sec. 263A, in determining the cost of goods sold, and sec. 861, in determining the source of such items). Other deductions, expenses or losses that are directly allocable to such receipts include, for example, selling and marketing expenses. A proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income include, for example, general and administrative expenses allocable to selling and marketing expenses. In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction.

Domestic production gross receipts

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;⁵⁴ (2) any sale, exchange or other disposition, or any lease, rental, or license, of qualified film produced by the taxpayer; (3) any sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction activities performed in the United States;⁵⁵ or (5) in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States for construction projects located in the United States.⁵⁶

However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person.⁵⁷ Further, domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment, that are derived from the transmission or distribution of electricity, gas, and potable water, or that are derived from the lease, rental, license, sale, exchange, or other disposition of land.⁵⁸

⁵⁴ Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange, or other disposition of agricultural products with respect to which the taxpayer performs storage, handling, or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth, or extraction of qualifying production property (whether or not by the taxpayer).

⁵⁵ For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting that is not performed in connection with activities that otherwise constitute substantial renovation.

⁵⁶ With regard to the definition of “domestic production gross receipts” as it relates to construction performed in the United States and engineering or architectural services performed in the United States for construction projects in the United States, the term refers only to gross receipts derived from the construction of real property by a taxpayer engaged in the active conduct of a construction trade or business, or from engineering or architectural services performed with respect to real property by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business.

⁵⁷ Sec. 199(c)(7). In general, principles similar to those under the extraterritorial income regime apply for this purpose. See Temp. Treas. Reg. sec. 1.927(a)-1T(f)(2)(i). For example, this exclusion generally does not apply to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. Similarly, the license of computer software to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as excluded property by reason of the license to the related person.

⁵⁸ Sec. 199(c)(4)(B).

Qualifying production property

Qualifying production property generally includes any tangible personal property, computer software, or sound recordings. Qualified film includes any motion picture film or videotape⁵⁹ (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (including compensation in the form of residuals and participations)⁶⁰ constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.⁶¹ A qualified film also includes any copyrights, trademarks, or other intangibles with respect to such film. The wage limitation for qualified films includes any compensation for services performed in the United States by actors, production personnel, directors, and producers and is not restricted to W-2 wages.⁶²

Other rules

Partnerships and S corporations.—With respect to the domestic production activities of a partnership or S corporation, the deduction under section 199 is applied at the partner or shareholder level.⁶³ In performing the calculation, each partner or shareholder generally takes into account such person's allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership or S corporation⁶⁴ as well as any items relating to the partner's or shareholder's own qualified production activities, if any. Each partner or shareholder is treated as having W-2 wages for the taxable year in an amount equal to such person's allocable share of the W-2 wages of the partnership or S corporation for the taxable year.⁶⁵

Trusts and estates.—In the case of a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary under regulations prescribed by the Secretary.⁶⁶

⁵⁹ See Treas. Reg. sec. 1.199-3(k).

⁶⁰ To the extent that a taxpayer has included an estimate of participations and/or residuals in its income forecast calculation under section 167(g), the taxpayer must use the same estimate of participations and/or residuals for purposes of determining total compensation.

⁶¹ Treas. Reg. sec. 1.199-2.

⁶² Sec. 199(b)(2)(D). Effective for tax years beginning after December 31, 2007.

⁶³ Sec. 199(d)(1)(A)(i).

⁶⁴ Sec. 199(d)(1)(A)(ii).

⁶⁵ Sec. 199(d)(1)(A)(iii).

⁶⁶ See Treas. Reg. secs. 1.199-5(d) and (e).

Agricultural and horticultural cooperatives.—With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, section 199 provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives,⁶⁷ or that are marketed through cooperatives, as it provides for qualified production activities income of other taxpayers, that is, the cooperative may claim a deduction from qualified production activities income.

Alternatively, section 199 provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the provision, is deductible from the gross income of the member. To qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income under section 1382 (e.g., cannot claim a dividends-paid deduction) for such amounts.

Alternative minimum tax.—The deduction for domestic production activities is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Description of Option

Small Business Tax Cut Act⁶⁸

In the case of a qualified small business, the option allows a deduction for 20 percent of qualified domestic business income of the taxpayer for the taxable year, or taxable income for the taxable year, whichever is less. However, a taxpayer's deduction for any taxable year may not exceed 50 percent of certain W-2 wages of the qualified small business.

W-2 wages

Limitation on deduction

⁶⁷ For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.

⁶⁸ H.R. 9, the "Small Business Tax Cut Act" (112th Congress), was introduced March 21, 2012, by Mr. Cantor with additional cosponsors and was referred to the Committee on Ways and Means. It was reported (as amended) by the Committee on Ways and Means on April 10, 2012 (H. Rep. 112-425, the Small Business Tax Cut Act, 112th Cong., 2d Sess., April 10, 2012), and was passed by the House of Representatives on April 19, 2012. The bill was received in the Senate April 23, 2012, and referred to the Committee on Finance.

The deduction is limited to 50 percent of the greater of (1) W-2 wages paid by the taxpayer to non-owner employees, or (2) the sum of W-2 wages paid by the taxpayer to (a) employees who are non-owner family members of direct owners and (b) employees who are 10-percent-or-less direct owners.

W-2 wages

For purposes of the option, W-2 wages include the sum of the amounts of wages as defined in section 3401(a) (i.e., wages subject to income tax withholding) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and designated Roth contributions (as defined in section 402A).

W-2 wages do not, however, include any amount not properly allocable to domestic business gross receipts under the option, nor does the term include any amount not allowed as a deduction under section 162 (relating to ordinary and necessary business expenses).⁶⁹

Certain partners' distributive shares of partnership items may be treated as W-2 wages solely for purposes of the option. In the case of a qualified small business that is a partnership and that so elects, the portion of the qualified domestic business taxable income of the partnership for the taxable year that is allocable to each qualified service-providing partner is treated as W-2 wages paid during that taxable year to an employee who is a 10-percent-or-less direct owner. The domestic business gross receipts of the partnership for the taxable year must be reduced by any amount treated as W-2 wages under this rule.

Non-owner employee

For purposes of the option, a non-owner employee of a qualified small business means a person who does not own (and is not considered as owning within the meaning of sections 267(c) or (e)(3), as applicable) any stock of the business or, if the business is not a corporation, any capital or profits interest of the business.

Non-owner family member employee

For purposes of this option, an individual is a non-owner family member of a direct owner if the individual is family (within the meaning of section 267(c)(4)⁷⁰) of a direct owner and would be considered a non-owner if sections 267(c) and (e)(3) were applied without regard

⁶⁹ For example, any amount paid to a household employee unrelated to the employer's trade or business is not allowed as a deduction under section 162 since the amount is not an ordinary and necessary business expense. However, amounts paid to employees engaged in the trade or business (regardless of whether such amounts are capitalized into the inventory or under any other provision requiring capitalization) would be qualifying wages for this provision, to the extent such wages are allocable to domestic business gross receipts.

⁷⁰ For this purpose, family includes only brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

to section 267(c)(2).⁷¹ For example, if the son of a direct owner of a corporation is not, himself, a direct owner of the stock of the corporation, is employed by the corporation, and receives W-2 wages from the corporation, the son is considered a non-owner family member of a direct owner.

Direct owner

For purposes of this option, a direct owner of a qualified small business is a person who owns (or is considered as owning under sections 267(c) or (e)(3) applied without regard to section 267(c)(2)) any stock of such business or, if the business is not a corporation, any capital or profits interest of the qualified small business. Thus, for example, in the case of tiered partnerships, for this purpose, a person who owns an interest in an upper-tier partnership is considered to own an interest in a lower-tier partnership that is a qualified small business.

10-percent-or-less direct owner

For purposes of the option, in the case of a qualified small business that is a corporation, a 10-percent-or-less direct owner means a direct owner who owns not more than 10 percent of the outstanding stock of the corporation or stock possessing not more than 10 percent of the total combined voting power of all stock of the corporation. In the case of a qualified small business that is not a corporation, a 10-percent-or-less direct owner means a person who owns not more than 10 percent of the capital or profits interest in the qualified small business.

Qualified service-providing partner

For purposes of this option, a qualified service-providing partner is any partner who is a 10-percent-or-less direct owner and who materially participates in the trade or business to which the qualified domestic business income relates.

Qualified domestic business income

In general

Qualified domestic business income, for any taxable year, means the excess (if any) of (1) the taxpayer's domestic business gross receipts for the taxable year, over the sum of (2) cost of goods sold allocable to such receipts, and the other expenses, losses, or deductions (other than the deduction allowed under this option) that are properly allocable to such receipts.

Domestic business gross receipts

Domestic business gross receipts means the gross receipts of the taxpayer that is a qualified small business which are effectively connected with the conduct of a trade or business within the United States within the meaning of section 864(c) determined without regard to paragraphs (3), (4), and (5) thereof and substituting "qualified small business (within the meaning of section 200)" for "nonresident alien individual or a foreign corporation" each place it

⁷¹ Sections 267(c) and (e)(3) provide constructive ownership rules for stock and passthrough entities. Section 267(c)(2) treats an individual as owning interests owned by the individual's family.

appears therein. Domestic business gross receipts do not include (1) gross receipts derived from the sale or exchange of a capital asset or property used in the trade or business (as defined in section 1231(b)), (2) royalties, rents, dividends, interest, or annuities, and (3) any amount which constitutes wages (as defined in section 3401).

Qualified small business

For purposes of the option, a qualified small business means an employer engaged in a trade or business if the employer had fewer than 500 full-time equivalent employees (“FTEs”)⁷² for either calendar year 2010 or 2011. For example, a C corporation, S corporation, partnership, or sole proprietorship with fewer than 500 FTEs in either calendar year 2010 or 2011 may be a qualified small business. In the case of an employer not in existence on January 1, 2012, the determination is made with respect to calendar year 2012 rather than 2010 or 2011.

In general, an employer’s FTEs are calculated by dividing the total hours of service for which wages were paid by the employer to employees during the taxable year by 2,080 hours.⁷³ This number is rounded down to the nearest whole number if not otherwise a whole number. Employers in existence for a partial calendar year annualize the number of FTEs calculated based on the number of calendar days the taxpayer was in existence during 2012.

Any employer that is treated as a single employer for purposes of section 52(a) or (b) (without regard to section 1563(b)), relating to employees of entities under common control, or section 414(m) or (o), relating to employees of an affiliated service group, is treated as a single employer for purposes of determining whether an employer is a qualified small business.

Other rules

Application to passthrough entities and individuals

For purposes of this option, rules similar to the rules under section 199 (described above) apply with respect to partnerships, S corporations, trusts or estates, or agricultural and horticultural cooperatives.⁷⁴ Rules similar to the rules under section 199 also apply with respect to individuals.⁷⁵

Special rule for affiliated groups

⁷² The term full-time equivalent employees for this purpose has the meaning given under section 45R(d)(2), without regard to section 45R(d)(5) and (e)(1) and by applying that subsection on a calendar year rather than a taxable year basis. Thus, for this purpose, seasonal employees and self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation and five percent owners of the employer are included in the calculation of an employer’s FTEs.

⁷³ For employees who work in excess of 2,080 hours during any taxable year, the excess is not taken into account. See sec. 45R(d)(2)(B).

⁷⁴ See sec. 199(d)(1) and (3).

⁷⁵ See sec. 199(d)(2).

All members of an expanded affiliated group are treated as a single corporation for purposes of the option.⁷⁶ Rules similar to the rules under section 199 apply to allocate the deduction among the members of the expanded affiliated group.⁷⁷

Alternative minimum tax

The deduction for qualified domestic business income is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified domestic business income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Coordination with section 199

If a taxpayer is allowed a deduction under this option for a taxable year, gross receipts of the taxpayer taken into account under this option cannot be taken into account under section 199 for the taxable year. Similarly, W-2 wages taken into account under this option cannot be taken into account under section 199 (which also has a limitation related to W-2 wages) for the taxable year. As a result, the taxpayer may not benefit under this option and under section 199 with respect to the same gross receipts or W-2 wages.

A taxpayer may elect not to take into account under this option any item of domestic business gross receipts. Under this election, for example, the taxpayer may treat an item of domestic business gross receipts as not taken into account under the option so that the item may be taken into account for purposes of section 199.

Regulations

The Treasury Department is directed to prescribe guidance necessary to carry out the purposes of the option. This guidance is to include rules preventing a taxpayer that reorganizes or changes its structure from being treated as a qualified small business if it would not have been so treated prior to the reorganization or structural change. The guidance is also to provide rules preventing taxpayers from obtaining a deduction under both section 199 and this option based on the same gross receipts or W-2 wages.

Effective Date

The option applies only with respect to the first taxable year of the taxpayer beginning after December 31, 2011.

⁷⁶ Members of an expanded affiliated group for purposes of this provision generally include those corporations which would be members of an affiliated group if such membership were determined based on an ownership threshold of “more than 50 percent” rather than “at least 80 percent.”

⁷⁷ See sec. 199(d)(4).

D. Corporate Integration

Present Law

Under present law, a corporation pays a tax on its taxable income, generally at a top rate of 35 percent.⁷⁸ To the extent that a corporation distributes its after-tax earnings and profits as a dividend to an individual shareholder, the recipient includes the amount of the dividend in gross income and pays tax at the shareholder's individual tax rate, except that qualified dividends are subject to tax at the rates applicable to net capital gain (in 2015). The after-tax earnings and profits of a corporation consist of earnings that have been taxed to the corporation and earnings that have not been subject to tax due to exclusions, accelerated deductions and credits. A tax is imposed at capital gain rates on the gain of a shareholder at the time the shareholder sells his or her stock.

Under present law, corporations receiving dividends from domestic corporations generally are allowed a deduction of 70 percent or more of the amount of the dividends received. Certain anti-abuse rules prevent corporations from receiving low-taxed dividends and creating a capital loss.⁷⁹ The dividends-received deduction on certain debt-financed portfolio stock is reduced.⁸⁰

Description of Option⁸¹

In 2003, the President's budget proposal for fiscal year 2004 contained a provision that would have exempted from shareholder tax dividends on which corporate tax had been paid. A substantially identical proposal was set forth in S. 2 (introduced by Senators Nickles and Miller) and in H.R. 2 (introduced by Chairman Thomas), on February 27, 2003.

The proposal was not enacted. Instead, Congress in 2003 enacted the present law rule that provides a reduced rate of shareholder tax for dividends that is the same as the reduced rate for capital gains.⁸² The description of the President's budget proposal for fiscal year 2004 that was prepared by the staff of the Joint Committee on Taxation⁸³ is reproduced below.

In general

⁷⁸ Lower rates apply to the first \$75,000 of taxable income. The benefits of the lower rates are phased-out.

⁷⁹ Secs. 246(c) and 1059.

⁸⁰ Sec. 246A.

⁸¹ The description reflects the proposal as set forth in H.R. 2 (introduced by Chairman Thomas) and S. 2 (introduced by Senators Nickles and Miller) on February 27, 2003.

⁸² Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27. See H. Rep. 108-126, Conference Report to accompany H.R. 2 (May 22, 2003). See also, Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05), May 2005.

⁸³ Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal (JCS-7-03), March 2003.

Under the proposal, the excludable portion of any dividend received by a shareholder is not included in gross income. The excludable portion of any dividend is the portion of the dividend which bears the same ratio to the dividend as the amount of the corporation's excludable dividend amount ("EDA") for a calendar year bears to all dividends paid by the corporation during the calendar year. The EDA, as discussed below, generally measures the corporation's fully taxed income reduced by taxes paid. In addition, shareholders may be allowed to increase the basis in their corporate stock to the extent the EDA exceeds the dividends paid by the corporation during the calendar year. These rules apply to both individual and corporate shareholders.⁸⁴

Excludable dividend amount

A corporation calculates an EDA that measures the amount of the corporation's income that was fully taxed reduced by taxes paid. The EDA, for any calendar year, includes an amount the numerator of which is the amount of Federal income tax⁸⁵ in excess of all nonrefundable credits (other than the foreign tax credit and the minimum tax credit attributable to any minimum tax imposed in a taxable year ending before April 1, 2001) shown on a corporation's income tax return filed during the preceding calendar year ("applicable income tax") and the denominator of which is the highest corporate tax rate (35 percent under present law).⁸⁶ An assessment of tax not shown on a return is treated as if it were an amount of tax shown on a return for the calendar year in which the tax is assessed. If a tax is paid after the close of the year that it is shown on a return or otherwise assessed, the tax is taken into account in the year paid. The EDA is decreased by the amount of the Federal income tax taken into account in computing the increase in the EDA. No tax imposed for a taxable year ending before April 1, 2001, is treated as an applicable income tax.⁸⁷

The EDA also includes the amount of dividends received from another corporation in the preceding calendar year that are excluded under this provision or amounts added to the basis of stock in the other corporation in the preceding calendar year (as described below).

⁸⁴ Certain taxable dividends received by a parent corporation from a subsidiary and taxable dividends received by a small business investment company will continue to receive a 100-percent dividends-received deduction to the extent not excludable.

⁸⁵ For this purpose, the income tax includes the taxes imposed on a corporation by sections 11 (corporate income tax), 55 (alternative minimum tax), 511 (unrelated business income tax), 801 (life insurance company income tax), 831 (nonlife insurance company income tax), 882 (income tax on foreign corporations connected with U.S. business), 1201 (alternative capital gain tax), and 1291 (without regard to section 1291(c)(1)(B)) (tax on distributions from a passive foreign investment companies) and 1374 (tax on built-in gains of S corporations). It also includes the accumulated earnings tax and the personal holding company tax prior to their repeal by the proposal.

⁸⁶ For this purpose, a timely filed return is treated as filed in the calendar year which includes the date that is the 15th day of the 9th month following the close of the corporation's taxable year.

⁸⁷ A corporation whose taxable year ends April 30, 2001, and that files a timely income tax return and pays the tax is treated for purposes of computing an EDA as having filed the return on January 15, 2002 (the date that is the 15th day of the 9th month following the close of the taxable year).

To the extent that the EDA for a calendar year exceeds the maximum amount of dividends that can be paid by the corporation in the calendar year (determined by reference to the corporation's earnings and profits), the excess is added to the EDA for the succeeding year. No other carryover of an amount in the EDA is allowed except to the extent provided by regulations.

Retained earnings basis adjustments

If the amount of the EDA for a calendar year exceeds the amount of dividends paid by a corporation during that year, a shareholder is allowed to increase the shareholder's basis in the corporation's stock by the portion (if any) of the excess allocated by the corporation to the stock. Basis increases are allocated by a corporation in the same manner as if the corporation actually had made dividend distributions, except that no amount may be allocated to stock described in section 1504(a)(4) (whether or not voting stock) that is limited and preferred as to dividends. The Secretary of the Treasury may prescribe regulations regarding allocations where a corporation has multiple classes of stock. Earnings and profits are adjusted in the same manner as if the allocation were a dividend (i.e., the distributing corporation's earnings and profits are reduced and, if the taxpayer receiving a basis adjustment is a corporation, that corporation's earnings and profits are increased). The allocated basis is added to the shares of stock the taxpayer holds and does not affect the holding periods of the shares.

Cumulative retained earnings basis adjustments account

Each corporation allocating basis adjustments is required to maintain a cumulative retained earnings basis adjustment account ("CREBAA"). The amount in the CREBAA is the cumulative amount of basis allocations for prior calendar years reduced by the amount of distributions in prior calendar years that were treated as described below.

To the extent of the amount in the CREBAA, distributions made by a corporation in a calendar year in excess of the amount in the EDA are not treated as dividends. Instead, the distributions reduce the basis of the shareholder's stock (or result in gain to the extent the distributions exceed the shareholder's basis).⁸⁸ These distributions reduce the amount in the CREBAA. The portion of any distribution to which this treatment applies is a fraction (not in excess of one) the numerator of which is the amount in the CREBAA account at the beginning of the calendar year and the denominator of which is the amount of all distributions (other than excluded dividends) paid by the corporation during the calendar year. This treatment is provided separately with respect to each class of stock for which a basis allocation was previously made.

For example, corporation X, a calendar year corporation, has a sole shareholder A. For its first taxable year, X has taxable income of \$100, and files a return and pays a tax of \$35 in its second taxable year. For all other taxable years in this example, X has no income or loss. On January 1 of its third taxable year, X has an EDA of \$65 (\$35/.35 less \$35). X pays no dividends in the third year but allocates \$65 of basis to A, and A increases its basis in the X stock by \$65. X has a CREBAA of \$65 at the beginning of the fourth year. The value of the X stock declines, and A sells the stock to B for \$50 at the beginning of the fourth year. A's gain or loss is computed by taking the \$65 into account in determining the basis in the X stock. X then

⁸⁸ For purposes of this description, these distributions are referred to as distributions from a CREBAA.

distributes \$65 to B later in the fourth year. B treats the \$65 as a \$50 reduction of the basis in the X stock to zero and a \$15 capital gain from the sale of the X stock. X will have no balance in its CREBAA at the beginning of the fifth year.

Credits and refunds of overpayments of tax

The overpayment of a corporate income tax (including an overpayment resulting by reason of a carryback) is allowed as a credit or refund only to the extent of the applicable income taxes taken into account in computing EDA for the calendar year following the calendar year in which the refund or credit is otherwise allowable plus, to the extent the corporation elects, an amount equal to the amount of tax that would produce the amount equal to the EDA for the calendar year in which the refund or credit is otherwise allowable. Thus, for example, assume a corporation has paid no tax in the current calendar year and has an EDA of \$65 for the current calendar year. The refund of any overpayment in the year is limited to \$35 (the amount of applicable income tax which results in an EDA of \$65).

To the extent a credit or refund is made, for purposes of computing EDA, the tax for the calendar year the refund or credit is made is reduced (but not below zero) by the amount of the credit or refund, and the excess (if any) reduces the amount in the EDA for the current calendar year, using the formula which converts applicable income tax to an EDA. Thus, in the above example, the EDA for the current calendar year is reduced to zero.

Any overpayment not allowed as a credit or refund by reason of this limitation continues to be an overpayment that will be taken into account in succeeding calendar years, subject to this limitation, until a credit or refund is allowed or made. Interest on an overpayment is not allowed during the period the overpayment is not allowed as a credit or refund by reason of this limitation.

This limitation does not apply to the extent any overpayment is attributable to the foreign tax credit.

Foreign taxes and foreign persons

Treatment of foreign taxes

The foreign tax credit allowable to a domestic corporation does not reduce the amount of the applicable income tax of the corporation. Thus, to the extent the foreign tax credit is allowable, foreign taxes of a domestic corporation are treated as taxes paid for purposes of computing the EDA.

Treatment of distributions from foreign corporations

The EDA of a foreign corporation takes into account only the tax on taxable income effectively connected with the conduct of a U.S. trade or business. The EDA is reduced by the amount of any branch profits tax imposed. Also, a foreign corporation's EDA is increased by (i) the excludable portion of any dividend received in excess of any U.S. withholding tax, and (ii) by the amount any distribution from a CREBAA in excess of any U.S. withholding tax.

No foreign tax credit is allowed with respect to the excludable portion of any dividend or from a distribution from a CREBAA.

Taxation of foreign shareholders

In the case of foreign shareholders, both individual and corporate, withholding taxes apply to all dividends and distributions from a CREBAA. Dividends are not treated as excludable and basis adjustments are not made with respect to stock held by foreign persons.

Regulated investment companies (RICs) and Real Estate Investment Trusts (REITs)

Except as provided in regulations, a regulated investment company (“RIC”) or real estate investment trust (“REIT”) does not have an EDA. Instead special rules allow the treatment of distributions received by, or basis adjustments allocated to, a RIC or REIT to pass through to its shareholders and holders of beneficial interests.

A RIC or REIT that receives excludable dividend income is allowed to designate dividends it makes to its shareholders as excludable dividends to the extent of the amount of excludable dividends it receives. In addition, a RIC or REIT may cause its shareholders to increase their bases in RIC or REIT stock to the extent of any basis increases allocated to stock held by the REIC or REIT. To the extent a RIC or REIT receives distributions from a CREBAA that reduce the basis of stock held by the RIC or REIT, distributions from the RIC or REIT may be treated as distributions from a CREBAA.

A RIC or REIT takes into account excludable dividends received, and distributions from a CREBAA that reduce the basis in stock it holds, in determining its distribution requirements. Excludable dividends and distributions from a CREBAA received by a RIC or REIT are taken into account in applying the gross income tests applicable to RICs and REITs.

If a shareholder or holder of a beneficial interest of a RIC or REIT receives an excludable dividend or is allocated a basis adjustment, any loss on the sale of the RIC or REIT stock held six months or less is disallowed to the extent of the amount of the exclusion or adjustment.

Insurance companies

Under the proposal, all excludable dividends received by a life insurance company are subject to proration. Thus, the excluded dividends are allocated on a pro rata basis between the insurance company’s general earnings and those amounts required to pay benefits. The basis increase allocated to an insurance company is treated as an excludable dividend received in the year the adjustment is made, and, as such, is subject to proration. All excludable dividends and basis increases attributable to assets held in a separate account funding variable life insurance and annuity contracts are allocated to the separate account. The policyholder’s share of excludable dividends and basis adjustments is includable in the company’s income. The company’s share of excludable dividends and basis adjustments is added to the shareholder’s surplus account of a stock life insurance company.

Excludable dividends and retained earnings basis adjustments of a non-life insurance company are treated in the same manner as taxable dividends in computing the reduction of the deduction for losses.

Partnerships and S corporations

Excluded dividends and basis adjustments received by, or allocated to, partnerships and S corporations

Excludable dividends received by a partnership and basis adjustments to stock held by a partnership pass through to the partners. A partner's adjusted basis in his or her partnership interest is adjusted to reflect excludable dividends and basis adjustments to stock held by a partnership.

Rules similar to the partnership rules apply to S corporations and their shareholders. In the case of S corporations, these amounts also increase the accumulated adjustments account of the corporation.

Distributions made by S corporations

The general provisions, as modified as described below, relating to excludable dividends, retained earnings basis adjustments, and distributions from a CREBAA apply to S corporations and their shareholders. An S corporation takes into account, in computing its EDA, the applicable income taxes imposed for a taxable year the corporation was a C corporation⁸⁹, and the tax imposed on built-in gains under section 1374. No amounts are added to an EDA by reason of excludable dividends received by, or basis adjustments allocated to, an S corporation; instead these dividends and basis adjustments flow thru to the shareholders as described above.

The items taken into account in determining the tax imposed on built-in gains under section 1374 no longer will pass through to the shareholders, so that S corporation shareholders generally will not pay a tax on the items which are taxed at the corporate level.⁹⁰ The amount of these items (determined without regard to any net operating loss from a C corporation year⁹¹ and reduced by the amount of the tax) increases the corporation's accumulated earnings and profits.

Under regulations, distributions of excludable dividends and amounts from a CREBAA will be treated as made before distributions from the accumulated adjustments account. Thus,

⁸⁹ For example, the applicable income taxes imposed shown on a return filed in the final year the corporation was a C corporation or the first year the corporation is an S corporation are taken into account in computing the EDA for years the corporation is an S corporation. Any tax imposed by reason of the LIFO recapture rules of section 1363(d) will be taken into account in computing the corporation's EDA under the usual rules relating to the filing of returns and the payment of tax.

⁹⁰ The tax imposed by section 1374 will no longer pass through to shareholders as a loss sustained by the S corporation.

⁹¹ A C corporation loss reduced the earnings and profits (or increased a deficit in earnings and profits) for the taxable year that the loss arose.

under the proposal, distributions by an S corporation with accumulated earnings and profits are made in the following order:

1. An excludable dividend to the extent of the EDA.
2. Reduction of basis (or recognition of gain) to the extent of the CREBAA.
3. Reduction of basis (or recognition of gain) to the extent of the accumulated adjustments account.
4. Taxable dividend to the extent of accumulated earnings and profits.
5. Reduction of basis.
6. Recognition of gain.

Treatment of passive investment income

The tax imposed on S corporation passive income is repealed. The provision terminating an S election as a result of passive income is also repealed.

Trusts and estates

The distributable net income of a trust or estate includes the excludable dividends received by the trust or estate and the distributions from a CREBAA received by the trust or estate.

Cooperatives

The EDA of a cooperative shall be allocated between shares of the corporation held by patrons and shares held by other persons as prescribed by regulations, and no deduction shall be allowed to the cooperative for any excludable dividend or distribution from a CREBAA paid to a patron.

Employee stock ownership plans (ESOPs)

Deductible dividends paid to an employee stock ownership plan (“ESOP”) are not treated as dividends for purposes of applying the rules under dividend exclusion rules added by the proposal. Thus, for example, they are disregarded in determining the excludable portion of dividends paid with respect to all dividends made by the corporation. Also, stock on which a deductible dividend may be made is disregarded for purposes of allocating basis adjustments and making distributions from a CREBAA.

Private foundations

Excludable dividends and distributions from a CREBAA will not be included in the calculation of net investment income of a private foundation for purposes of the tax imposed by section 4940.

Anti-abuse rules

If a shareholder does not hold stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (as measured under section 246(c))⁹², the basis of the stock is reduced by the amount of any excludable dividends and allocated basis adjustments. Also, no deduction is allowable with respect to payments related to an excludable dividend or basis increase.

The rules of section 1059 requiring a basis reduction with respect to certain extraordinary dividends are made applicable to the excludable dividends received by, and basis adjustments allocated to, both corporate and noncorporate shareholders. Except as provided by regulations, if an excludable dividend is received, or a basis adjustment is allocated, with respect to a share of stock, the basis reduction applies to that share of stock, without regard to whether the excludable dividend or basis adjustment otherwise would be extraordinary, if received during the first year (or such other period provided by regulations) the taxpayer holds the stock.⁹³

In the case of a corporate shareholder, the EDA and the earnings and profits are not increased by any amounts that result in a basis decrease under these rules.

Shareholder indebtedness

In the case of debt-financed portfolio stock held by a corporation, the excludable portion of a dividend is reduced by the average indebtedness percentage (as defined in section 246A) applicable to the stock. Also, there is included in gross income an amount equal to the basis adjustment to any stock held by the taxpayer multiplied by the average indebtedness percentage. The EDA of a corporate shareholder is not increased by any amount included in gross income by reason of this rule.

The investment interest limitations of section 163(d) for individuals apply. In addition, any excludable dividend is not investment income.

Redemptions

The present law rules relating to the treatment of redemptions of stock (either directly by a corporation or through the use of a related corporation) as a dividend or as an exchange remain the same as under present law. Redemptions treated as exchanges reduce the EDA and CREBAA by the ratable share of the amount attributable to the shares redeemed.

Tax-free reorganizations and liquidations

In the case of a tax-free reorganization or liquidation, the current rules providing for the carryover of tax attributes are amended to provide for the carryover of the acquired corporation's EDA and CREBAA. In the case of a tax-free spin-off, the CREBAA is divided between the

⁹² In the case of preferred stock, the periods are doubled.

⁹³ For this purpose, the holding period of stock acquired from a decedent is determined without regard to the rule otherwise providing for long-term capital gain treatment for the stock (sec. 1223(11)).

distributing and controlled corporations in accordance with regulations provided by the Secretary of the Treasury.

Rights to acquire stock

The Secretary of the Treasury may promulgate regulations treating the holder of a right to acquire stock as the holder of stock and regulations amending the option attribution rules.

Alternative minimum tax

Excluded dividends and reduced gain (or increased loss) resulting from the allocated basis adjustments are not an item of tax preference or adjustment for purposes of determining alternative minimum taxable income (including the determination of adjusted current earnings for corporations).

Accumulated earnings tax and personal holding company tax

The accumulated earnings tax and the personal holding company tax are repealed, for taxable years beginning after December 31, 2002, except that any deficiency dividend or dividend paid on or before the 15th day of the third month after the close of the taxable year which is taken into account in computing the tax for a taxable year beginning before that date may be made. Such a dividend is not treated as a dividend for purposes of applying the dividend exclusion rules of the proposal.

Compliance

Form 1099 will be revised to provide information to shareholders to indicate the amount of excludable dividends and the amount of basis adjustments and the date they are allocated.

A corporation will calculate the EDA and CREBAA and report those amounts to the IRS annually on its income tax return.

Regulations

The Secretary of the Treasury is provided authority to prescribe appropriate regulations to carry out these provisions.

The Secretary of the Treasury may amend the consolidated return regulations (effective as of the effective date of the proposal) to properly account for an EDA of a member of the group, for basis adjustments allocated to a member of the group, and for CREBAA distributions received by a member of the group. These regulations may accelerate the inclusion in the excludable dividend amount with respect to activities of lower-tier members of the group, excludable dividends received from lower-tier members, and increases in basis allocated to stock in lower tier members.

Effective Date

In general

The proposal applies to distributions (and basis adjustments) made after December 31, 2002, with respect to taxes paid for taxable years ending on or after April 1, 2001. Thus, for example, a calendar year corporation that filed its 2001 federal income tax return and paid tax on September 15, 2002, may pay excluded dividends or allocate basis adjustments beginning January 1, 2003, based on the amount of tax paid with respect to its taxable income for 2001.

Dividends-received deduction

The present law dividends received deduction continues to apply to distributions (not otherwise treated as excludable dividends) of earnings and profits accumulated in taxable years ending before April 1, 2001, that are distributed before January 1, 2006, with respect to stock issued before February 3, 2003.

Repeal of accumulated earnings tax, personal holding company tax and tax on passive income of S corporations

These taxes are repealed for taxable years beginning after December 31, 2002.

S corporation tax on built-in-gains

The provisions relating to the tax on the built-in gains of S corporations (section 1374) are effective for taxes imposed in taxable years beginning after December 31, 2002.⁹⁴

⁹⁴ This effective date prevents a change in the taxation of S corporation shareholders for taxable years beginning before January 1, 2003.

E. Depreciation of Tangible Property

Present Law

Overview

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income.⁹⁵ Under the modified accelerated cost recovery system (“MACRS”), adopted in 1986, the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.⁹⁶

Recovery periods and depreciation methods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.⁹⁷ The “type of property” of an asset is used to determine the “class life” of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,⁹⁸ switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year will yield a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for

⁹⁵ Sec. 167(a).

⁹⁶ The Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 201 (1986).

⁹⁷ Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56 (1987-2 C.B. 674), laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22 (1988-1 C.B. 785). In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

⁹⁸ Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of \$1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight-line method.

Recovery method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
200-percent declining balance	285.71	204.08	145.77	104.12	86.77	86.77	86.77	1,000.00
150-percent declining balance	214.29	168.37	132.29	121.26	121.26	121.26	121.26	1,000.00
Straight-line	142.86	142.86	142.86	142.86	142.86	142.86	142.86	1,000.00

residential rental property. Table 1 provides general rules for class lives and recovery periods as provided in sections 168(c) and (e).

Table 1.—General Rules for Class Lives and Recovery Periods

Type of Property	General Rule-Class Life	MACRS Applicable Recovery Period
3-year property	4 years or less	3 years
5-year property	More than 4 but less than 10 years	5 years
7-year property	10 or more but less than 16 years; also, property (other than real property) without a class life	7 years
10-year property	16 or more but less than 20 years	10 years
15-year property	20 or more but less than 25 years	15 years
20-year property	25 or more years	20 years
Water utility property	50 years	25 years
Residential rental property	40 years	27.5 years
Nonresidential real property	40 years	39 years
Any railroad grading or tunnel bore	50 years	50 years

Placed-in-service conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.⁹⁹ Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.¹⁰⁰ All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year.¹⁰¹ However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-

⁹⁹ Treas. Reg. sec. 1.167(a)-10(b).

¹⁰⁰ Secs. 168(d)(2) and (d)(4)(B).

¹⁰¹ Secs. 168(d)(1) and (d)(4)(A).

quarter convention,¹⁰² designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

Alternative depreciation system

The alternative depreciation system (“ADS”) is required to be used for property used predominantly outside the United States, tax-exempt bond financed property, and certain tax-exempt use property.¹⁰³ An election to use ADS is available to taxpayers for any class of property for any taxable year.¹⁰⁴ Under ADS, all property is depreciated using the straight-line method, over recovery periods which generally are equal to the class life of the property, with certain exceptions.¹⁰⁵

Like-kind exchanges

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a “like-kind” which is to be held for productive use in a trade or business or for investment.¹⁰⁶ If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange. In general, section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.¹⁰⁷

Involuntary conversions

Although gain or loss realized from the sale or other disposition of property must generally be recognized, section 1033 provides an exception to this rule in the case of certain involuntary conversions of property. Section 1033 applies if property is involuntarily or compulsorily converted into similar property or money. Such a conversion may occur as a result of the property’s destruction (in whole or in part), theft, seizure, requisition or condemnation, or a sale made under the threat of requisition or condemnation.¹⁰⁸

¹⁰² The mid-quarter convention treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter. Secs. 168(d)(3) and (d)(4)(C).

¹⁰³ Sec. 168(g).

¹⁰⁴ Sec. 168(g)(7).

¹⁰⁵ Sec. 168(g)(2).

¹⁰⁶ Sec. 1031(a)(1).

¹⁰⁷ Sec. 1031(a)(2).

¹⁰⁸ Sec. 1033(a).

For purposes of section 1033, condemnation refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation.¹⁰⁹ Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or a threat of imminence thereof), and the divestiture is not eligible for deferral under this provision.¹¹⁰

If property is involuntarily converted into property that is similar or related in service or use to the property so converted, no gain is recognized. This treatment is not elective. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. If the taxpayer receives money (for instance, insurance payments or condemnation awards), or other dissimilar property for the involuntarily converted property, and acquires qualified replacement property within the prescribed time period, nonrecognition of the gain is optional.¹¹¹ As a general matter, the prescribed time period begins on the date of the disposition of the converted property (or threat or imminence of a threat of condemnation begins) and ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.¹¹²

The taxpayer's basis in the replacement property is the same as the taxpayer's basis in the converted property, decreased by the amount of any money received or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.¹¹³

Description of Options

The Senate Committee on Finance Chairman's Staff Discussion Draft To Reform Certain Business Options - Pooled Asset Cost Recovery System and Depreciation of Real Property¹¹⁴

In general

This option repeals present-law depreciation rules under section 168 and replaces such rules with a pooling cost recovery system for "pooled property" (*e.g.*, most tangible property and

¹⁰⁹ Rev. Rul. 58-11, 1958-1 C.B. 273.

¹¹⁰ *Ibid.* If the replacement property is stock of a corporation and if the stock basis is decreased under this rule, the aggregate basis of the corporation's assets is likewise decreased by the same amount (but not below that stock basis as so decreased). Sec. 1033(b)(3).

¹¹¹ Sec. 1033(a)(2)(A).

¹¹² Sec. 1033(a)(2)(B).

¹¹³ Sec. 1033(b).

¹¹⁴ MCG13833, available at <http://www.finance.senate.gov/newsroom/chairman/release/index.cfm>: "Baucus Works to Overhaul Outdated Tax Code," November 21, 2013. See also, Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft to Reform Certain Business Options* (JCX-19-13), November 21, 2013.

computer software) and a straight-line cost recovery system for “straight-line property” (*i.e.*, real property and personal-use passenger automobiles) (collectively, “section 168 property”). The term “section 168 property” does not include motion picture films, video tapes, or sound recordings.¹¹⁵

Pooled property

In general

In the case of pooled property, costs are recovered by multiplying the applicable recovery rate for each pool by the associated pool balance at year-end. “Pooled property” is defined as any tangible property (other than any personal-use passenger automobile) and any computer software (as defined in section 197(e)(3)(B) that is not an amortizable section 197 intangible) assigned to any one of the four pools (detailed in Table 2 below).

Table 2.–Pooled Property by Pool

Property	Classification ¹¹⁶
POOL 1	
Information systems	00.12
Data handling equipment, except computers	00.13
Automobiles, taxis	00.22
Electric utility nuclear fuel assemblies	49.121
Computer software	Section 168(b)(2)(B) ¹¹⁷
POOL 2	
Buses	00.23
Light general purpose trucks	00.241
Heavy general purpose trucks	00.242

¹¹⁵ “Sound recordings” are any works resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material (*e.g.*, discs, tapes, or other phonorecordings) in which such sounds are embodied.

¹¹⁶ Except where noted, the classification is based on the asset class categorization provided in Rev. Proc. 87-56, 1987-2 C.B. 674. Any reference to Rev. Proc. 87-56 shall include any amendment to such revenue procedure (*e.g.*, Rev. Proc. 88-22, 1988-1 C.B. 785). The assignment of asset classes based on the categorization provided in Rev. Proc. 87-56 is not intended to disrupt IRS guidance (*e.g.*, Rev. Proc. 2011-22, 2011 I.R.B. 737).

¹¹⁷ The section number refers to computer software described in such section of the discussion draft.

Property	Classification¹¹⁶
Tractor units for use over-the-road	00.26
Trailers and trailer-mounted containers	00.27
Agriculture	01.1
Cotton ginning assets	01.11
Cattle, breeding or dairy	01.21
Any breeding or work horse that is 12 years old or less at the time it is placed in service	01.221
Any breeding or work horse that is more than 12 years old at the time it is placed in service	01.222
Any race horse that is more than two years old at the time it is placed in service	01.223
Any horse that is more than 12 years old at the time it is placed in service and that is neither a race horse nor a horse described in class 01.222	01.224
Any horse not described in classes 01.221, 01.222, 01.223, or 01.224	01.225
Hogs, breeding	01.23
Sheep and goats, breeding	01.24
Construction	15.0
Manufacture of medical and dental supplies	22.3
Cutting of timber	24.1
Sawing of dimensional stock from logs (permanent)	24.2
Sawing of dimensional stock from logs (temporary)	24.3
Manufacture of wood products and furniture	24.4
Manufacture of rubber products	30.1
Manufacture of finished plastic products	30.2
Manufacture of electronic components, products and systems	36.0

Property	Classification¹¹⁶
Manufacture of semiconductors	36.1
Manufacture of motor vehicles	37.11
Railroad machinery and equipment	40.1
Motor transport—Passengers	41.0
Motor transport—Freight	42.0
Telephone central office equipment	48.12
Computer-based telephone central office switching equipment	48.121
Telephone station equipment	48.13
Radio and television broadcastings	48.2
TOCSC ¹¹⁸ —High frequency radio and microwave system	48.32
TOCSC—Central office control equipment	48.34
TOCSC—Computerized switching, channeling, and associated control equipment	48.35
TOCSC—Satellite space segment property	48.37
TOCSC—Equipment installed on customer’s premises	48.38
TOCSC—Support and service equipment	48.39
Distributive trades and services	57.0
Recreation	79.0
Qualified rent to own property	Section 168(i)(14) ¹¹⁹
Tree or vine bearing fruit or nuts	Section 168(e)(3)(D)(ii) ¹²⁰

¹¹⁸ “TOCSC” stands for telegraph, ocean cable, and satellite communications.

¹¹⁹ The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

¹²⁰ The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

Property	Classification ¹¹⁶
POOL 3	
Office Furniture, fixtures and equipment	00.11
Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters	00.21
Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction	00.28
Mining	10.0
Offshore drilling	13.0
Drilling of oil and gas wells	13.1
Exploration for and production of petroleum and natural gas deposits	13.2
Petroleum refining	13.3
Manufacture of grain and grain mill products	20.1
Manufacture of sugar and sugar products	20.2
Manufacture of vegetable oils and vegetable oil products	20.3
Manufacture of other food and kindred products	20.4
Manufacture of food and beverages—Special handling devices	20.5
Manufacture of tobacco and tobacco products	21.0
Manufacture of knitted goods	22.1
Manufacture of yarn, thread, and woven fabric	22.2
Manufacture of carpets, and dyeing, finishing, and packaging of textile products	22.3
Manufacture of textured yarns	22.4
Manufacture of nonwoven fabrics	22.5
Manufacture of apparel and other finished products	23.0

Property	Classification¹¹⁶
Manufacture of pulp and paper	26.1
Manufacture of converted paper, paperboard, and pulp products	26.2
Printing, publishing, and allied industries	27.0
Manufacture of chemicals and allied products	28.0
Manufacture of rubber products–Special tools and devices	30.11
Manufacture of finished plastic products–Special tools	30.21
Manufacture of leather and leather products	31.0
Manufacture of glass products	32.1
Manufacture of glass products–Special tools	32.11
Manufacture of cement	32.2
Manufacture of other stone and clay products	32.3
Manufacture of primary nonferrous metals	33.2
Manufacture of primary nonferrous metals–Special tools	33.21
Manufacture of foundry products	33.3
Manufacture of primary steel mill products	33.4
Manufacture of fabricated metal products	34.0
Manufacture of fabricated metal products – Special tools	34.01
Manufacture of electrical and non-electrical machinery and other mechanical products	35.0
Manufacture of motor vehicles–Special tools	37.12
Manufacture of aerospace products	37.2
Ship and boat building machinery and equipment	37.31

Property	Classification¹¹⁶
Ship and boat building –Special tools	37.33
Manufacture of locomotives	37.41
Manufacture of railroad cars	37.42
Manufacture of athletic, jewelry and other goods	39.0
Air transport	45.0
Air transport (restricted)	45.1
CATV ¹²¹ –Program origination	48.43
CATV–Service and test	48.44
CATV–Microwave systems	48.45
Personal property not assigned a class life	
POOL 4	
Railroad cars and locomotives, except those owned by railroad transportation companies	00.25
Land improvements	00.3
Industrial steam and electric generation and/or distribution systems	00.4
Ship and boat building dry docks and land improvements	37.32
Railroad wharves and docks	40.3
Railroad track	40.4
Railroad hydraulic electric generating equipment	40.51
Railroad nuclear electric generating equipment	40.52
Railroad steam electric generating equipment	40.53
Railroad steam, compressed air, and other power plant equipment	40.54

¹²¹ “CATV” stands for cable television.

Property	Classification¹¹⁶
Water transportation	44.0
Pipeline transportation	46.0
Telephone distribution plant	48.14
TOCSC–Electric power generating and distribution systems	48.31
TOCSC–Cable and long-line systems	48.33
TOCSC–Satellite ground segment property	48.36
CATV–Headend	48.41
CATV–Subscriber connection and distribution systems	48.42
Electric utility transmission and distribution plant	49.14
Gas utility distribution facilities	49.21
Gas utility trunk pipelines and related storage facilities	49.24
Water utilities	49.3
Central steam utility production and distribution	49.4
Municipal sewer	51.0
Distributive trades and services–Billboard, service station buildings and petroleum marketing land improvements	57.1
Theme and amusement parks	80.0
Real property that is section 1245 property ¹²² not assigned a class life	
Solar and wind energy	Section 168(e)(3)(B)(vi) ¹²³

¹²² “Section 1245 property” refers to an asset defined under such section as in effect for taxable years beginning in 2014.

¹²³ The section number refers to an asset described in such section as in effect for taxable years beginning in 2014.

Applicable rates

The applicable recovery rates for the four pools are:

- Pool 1: 38 percent;
- Pool 2: 18 percent;
- Pool 3: 12 percent; and
- Pool 4: five percent.

Foreign assets

In instances where assets used predominantly outside the United States (“foreign assets”) and assets used predominantly inside the United States (“domestic assets”) are owned by (and used in) the same trade or business, the foreign assets must be pooled separately from the domestic assets in order to permit necessary foreign sourcing calculations and any other necessary allocations with respect to foreign assets. Thus, a trade or business with both foreign assets and domestic assets may have two of each pool.

Pool balances

In general

To determine an asset pool balance as of the close of the taxable year, a taxpayer generally must take in to account additions to and subtractions from the pool as well as any depreciation deduction or negative pool balance adjustment (discussed below).

First taxable year.—For the first taxable year beginning after December 31, 2014, each asset pool balance is determined by:

(1) adding the adjusted basis of (A) any pooled property held by the taxpayer on the first day of such taxable year assigned to such asset pool;¹²⁴ (B) any pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and (C) to the extent not already included by reason of (B), any capitalizable addition or improvement made to pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and

(2) subtracting (A) the amount of any reduction pursuant to a discharge of indebtedness;¹²⁵ (B) except as provided in (C), the gross proceeds from the disposition or transfer during the taxable year of any asset assigned to such pool; and (C) in the case of any pooled property disposed of or transferred to a related person or tax shelter or any other pooled property which the taxpayer continues to use after its disposition, the recomputed basis (discussed below).

¹²⁴ The term “any pooled property held by the taxpayer” includes pooled property with zero adjusted basis.

¹²⁵ For this purpose, the relevant subsections are (b)(2)(E), (b)(5), and (c)(1) of section 108, as amended by the discussion draft.

Subsequent taxable years.—For each subsequent taxable year, a taxpayer must first compute each asset pool’s adjusted balance. The adjusted balance of an asset pool is the prior year’s ending pool balance decreased by the amount of any depreciation deduction claimed with respect to such pool and increased by the amount of any gain recognized with respect to a negative pool balance for such pool. To determine the pool balance as of the close of the taxable year, a taxpayer begins with the adjusted balance then:

(1) adds the adjusted basis of: (A) any pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and (B) to the extent not already included by reason of (A), any capitalizable addition or improvement made to pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and

(2) subtracts: (A) the amount of any reduction pursuant to a discharge of indebtedness;¹²⁶ (B) except as provided in (C), the gross proceeds from the disposition or transfer during the taxable year of any asset assigned to such pool; and (C) in the case of any pooled property disposed of or transferred to a related person or tax shelter or any other pooled property which the taxpayer continues to use after its disposition, the recomputed basis (discussed below).

Pooling example

Suppose a calendar year taxpayer offers music lessons at a studio. The taxpayer owns the following assets on January 1, 2015, each with an adjusted basis as indicated: (1) \$1,000 computers (asset class 00.12 under Revenue Procedure 87-56); (2) \$1,000 light truck (asset class 0.241 under Revenue Procedure 87-56) used 100 percent for business use; (3) \$1,000 violin (personal property not assigned a class life under Revenue Procedure 87-56); and (4) \$1,000 sidewalks and other land improvements around the studio (asset class 00.3 under Revenue Procedure 87-56). As of January 1, 2015, the taxpayer has a pool balance of \$1,000 in each of pools one through four.

On February 1, 2015, the taxpayer acquires a new computer for \$2,000. On March 1, 2015, the taxpayer sells the violin to an unrelated party for \$1,500. On March 2, 2015, the taxpayer acquires a viola for \$1,700. On April 1, 2015, the taxpayer sells the light truck for \$500 and acquires a new light truck for \$1,500. The taxpayer makes no improvements to the land around the studio or to the building in 2015. The following describes the depreciation deductions allowable to the taxpayer.

Pool 1: The beginning balance of pool 1 is \$1,000. The taxpayer acquired a new computer for \$2,000 and added it to the pool for a balance of \$3,000. The applicable rate of depreciation for assets in pool 1 is 38 percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 1 of \$1,140 (0.38 multiplied by \$3,000). The \$1,140 of depreciation for 2015 is deducted from the balance of pool 1, resulting in a balance of \$1,860 for the beginning of 2016.

¹²⁶ For this purpose, the relevant subsections are (b)(2)(E), (b)(5), and (c)(1) of section 108, as amended by the discussion draft.

Pool 2: The beginning balance of pool 2 is \$1000. During 2015, the taxpayer sells the light truck for \$500 and acquires another for \$1500, to be used 100 percent for business use. The balance of pool 2 is reduced by the proceeds of the sale of the old truck and is increased by the basis of the new truck. The pool balance before depreciation is \$2000 ($\$1000 - \$500 + \1500). The applicable rate of depreciation for assets in pool 2 is 18 percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 2 of \$360 (0.18 multiplied by \$2000). The taxpayer recognizes no loss on the sale of the old truck. However, the taxpayer is permitted to continue to recover the remaining basis in the old truck, thus recognizing the loss over time. The \$360 of depreciation is deducted from the balance of pool 2, resulting in a balance of \$1,640 for the beginning of 2016.

Pool 3: The beginning balance of pool 3 is \$1,000. In 2015, the taxpayer sold a violin to an unrelated party for \$1,500 and acquired a viola for \$1,700. The balance of pool 3 is reduced by the proceeds of the sale of the violin but is increased by the basis of the viola. The pool balance before depreciation is \$1,200 ($\$1,000 - \$1,500 + \$1,700$). The applicable rate of depreciation for assets in pool 3 is 12 percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 3 of \$144 (0.12 multiplied by \$1,200). The taxpayer recognizes no gain on the sale of the violin. However, the taxpayer is only permitted to depreciate \$1,200 of the cost of the viola, rather than \$1,700. The \$144 of depreciation for 2015 is deducted from the balance of pool 3, resulting in a balance of \$1,056 for the beginning of 2016.

Pool 4: The beginning balance of pool 4 is \$1,000. The taxpayer has no additions to the pool for 2015. The applicable rate of depreciation for assets in pool 4 is five percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 4 of \$50 (0.05 multiplied by \$1,000). The \$50 of depreciation for 2015 is deducted from the balance of pool 4, resulting in a balance of \$950 for 2016.

The taxpayer is allowed a total deduction for depreciation in 2015 with respect to his trade or business of \$1,694 ($\$1,140 + \$360 + \$144 + \50).

Special rules

In general, pool balances that are less than zero at year-end (“negative pool balances”) give rise to section 1245 gain. As previously discussed, the amount of section 1245 gain recognized is added to the pool balance to restore such pool balance to zero. For example, suppose that the taxpayer in the above example above had not purchased a viola in 2015. The proceeds from the sale of the violin are still subtracted from the balance of pool 3, resulting in a balance before depreciation of $-\$500$ ($\$1,000 - \$1,500$). The \$500 negative balance is treated as gain from the disposition of section 168 property for purposes of section 1245. Thus, the taxpayer recognizes \$500 of gain as ordinary income. The balance of pool 3 is increased by the amount of gain recognized, restoring the taxpayer’s pool balance to zero for the subsequent year’s calculation.

Similarly, if there are no assets remaining in a pool at year-end, any positive year-end balance in the pool may be deducted as a terminal loss with respect to that pool. Additionally, a taxpayer may deduct any pool balance at year-end of \$1,000 or less (“*de minimis* balance”). Any amount deducted as a terminal loss or *de minimis* balance with respect to a pool is an ordinary

loss and is subtracted from the pool balance to restore the taxpayer's pool balance to zero for the subsequent year's calculation.

Leasebacks and dispositions to related parties and tax shelters

In the case of pooled property disposed of or transferred to a related person or to a tax shelter, the pool balance is reduced by the lesser of the recomputed basis or the gross proceeds from the sale. The recomputed basis of any pooled property is determined by calculating the pool balance as if such property (including any additions or improvements to such property) had been the only property assigned to such pool since acquisition. A "related person" is related to any other person if the related person bears a relationship to such other person described in section 267(b) or 707(b)(1) or the related person and such other person are engaged in a trade or business under common control (within the meaning of sections 41(f)(1)(A) and (B)).¹²⁷ A tax shelter has the meaning given such term in section 461(i)(3).

If a taxpayer continues to use pooled property after its disposition (*e.g.*, sale-lease-back transaction), the pool balance is reduced by the lesser of the recomputed basis (as defined above) or gross proceeds from the sale.

The excess of the fair market value of the property disposed of or transferred over the recomputed basis is treated as section 1245 gain.¹²⁸ The purchaser (or transferee) adds the asset to the appropriate pool at its purchase price.

Straight-line property

In the case of straight-line property, costs are recovered ratably (without regard to salvage value) over the applicable recovery period, beginning with the midpoint of the month in which the asset is placed in service. "Straight-line property" is comprised of tangible property classified as real property and any personal-use automobile.

Real property

"Real property" is defined as (1) any residential rental property (as defined in section 168(e)(2)(A) prior to the enactment of this option); (2) any nonresidential real property (as defined in section 168(e)(2)(B) prior to the enactment of this option); (3) any qualified second generation biofuel plant property (as defined in section 168(l) prior to enactment of this option); and any asset treated under Revenue Procedure 87-56¹²⁹ as belonging to one of the asset classes in the below. Table 3 includes all assets classified as "real property."

¹²⁷ A person is treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the property involved.

¹²⁸ For a discussion of section 1245 gain, see Section 12, Rules related to treatment of gains from depreciable property.

¹²⁹ Rev. Proc. 87-56, 1987-2 C.B. 674. Any reference to Rev. Proc. 87-56 shall include any amendment to such revenue procedure (*e.g.*, Rev. Proc. 88-22, 1988-1 C.B. 785).

Table 3.–Real Property

Property	Classification¹³⁰
Farm building except structures include in class 01.4	01.3
Single purpose agricultural or horticultural structures	01.4
Railroad structures and similar improvements	40.2
Telephone central office buildings	48.11
Electric utility hydraulic production plant	49.11
Electric utility nuclear production plant	49.12
Electric utility steam production plant	49.13
Electric utility combustion turbine production plant	49.15
Gas utility manufactured gas production plants	49.221
Gas utility substitute natural gas (SNG) production plant (naphtha or lighter hydrocarbon feed stocks)	49.222
Substitute natural gas-coal gasification	49.223
Natural gas production plant	49.23
Liquefied natural gas plant	49.25
Waste reduction and resource recovery plants	49.5
Municipal wastewater treatment plant	50.0
Residential rental property	Section 168(e)(2)(A) ¹³¹
Nonresidential real property	Section 168(e)(2)(B) ¹³²
Qualified second generation biofuel plant property	Section 168(l)(2) ¹³³

¹³⁰ Except where noted, the classification is based on the asset class categorization provided in Rev. Proc. 87-56, 1987-2 C.B. 674. Any reference to Rev. Proc. 87-56 shall include any amendment to such revenue procedure (e.g., Rev. Proc. 88-22, 1988-1 C.B. 785).

¹³¹ The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

¹³² The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

The applicable recovery period for real property is 43 years.

A transition rule applicable to all straight-line property (including real property) placed in service in a taxable year beginning before January 1, 2015, provides that the adjusted basis of such real property is depreciated over a term of 43 years reduced by the number of taxable years for which the property has already been depreciated.¹³⁴ For example, assume a taxpayer purchased residential rental property for \$907,500 and placed such property in service on June 15, 2005. Under the transition rule, for taxable years beginning on or after January 1, 2015, the taxpayer recovers the remaining basis of \$594,000¹³⁵ over 33 years (43 years minus the 10 years the property has already been depreciated). Thus, the taxpayer is allowed depreciation deductions of \$18,000 per year for 33 years (instead of \$33,000 for the remaining 17.5 years) for the remaining basis.¹³⁶

Personal-use passenger automobiles

A “personal-use passenger automobile” is defined as any passenger automobile that is used for business less than 100 percent of the time. A passenger automobile for this purpose is any four-wheeled vehicle that is (1) manufactured primarily for use on public streets, roads, and highways and (2) rated at 6,000 pounds unloaded gross vehicle weight or less.¹³⁷ Excluded from the definition of a passenger automobile is (1) any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in their trade or business and (2) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire. The applicable recovery period for personal-use passenger automobiles is five years. The amount of depreciation with respect to any personal-use passenger automobile may not exceed \$45,000 in total.¹³⁸

¹³³ The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

¹³⁴ The first year the real property is placed in service is considered an entire year for purposes of the transition rule. For example, assume a calendar-year taxpayer places real property in service in June of 2012 and begins depreciating such amount. For purposes of the transition, the taxpayer is deemed to have amortized the intangible for four years as of January 1, 2015. Therefore, the remaining basis of the real property as of January 1, 2015 is depreciated over 39 years (43 years minus four years for which the real property had already been depreciated).

¹³⁵ Prior to enactment of this option, the taxpayer would have taken \$16,500 (half of \$907,500 divided by 27.5 years) of depreciation for the first year and \$33,000 of depreciation (\$907,500 divided by 27.5 years) for the subsequent nine years (January 1, 2006 to December 31, 2014).

¹³⁶ For purposes of this transition rule only, the computation is made as if the remaining basis of the property was placed in service on the first day of the taxable year for which the option is effective and disposed of on the last day of the final taxable year in question. If the property is disposed of prior to being fully depreciated, the mid-month convention for determining the depreciation for the year of disposition applies.

¹³⁷ In the case of a truck or van, “gross vehicle weight” is replaced with “unloaded gross vehicle weight.”

¹³⁸ The \$45,000 limitation is provided in section 13 of the discussion draft, Limitation on depreciation of personal use passenger automobiles, modifying section 280F.

The transition rule applicable to all straight-line property (including any personal-use passenger automobile) placed in service in a taxable year beginning before January 1, 2015, provides that the adjusted basis of the personal-use passenger automobile¹³⁹ is depreciated over a term of five years reduced by the number of taxable years for which the automobile had already been depreciated.¹⁴⁰

Assignments, classifications, and modifications

The option grants the Secretary¹⁴¹ authority to issue guidance to: (1) reclassify assets (or categories of assets) as real property or as pooled property; (2) reclassify assets (or categories of assets) to different pools; and (3) modify asset classes described in Revenue Procedure 87-56 or create new categories of assets. Any reclassifications or reassignments must be made based on the anticipated useful life and the anticipated decline in value over time of the asset and after taking into account when the asset is technologically or functionally obsolete. Further, in any case where the Secretary makes a modification, the Secretary must publish a schedule reflecting all classifications and assignments (including the modification(s) to such classifications and assignments) for all section 168 property. Such publication is treated as a major rule for purposes of applying chapter 8 of title 5 of the United States Code, the Congressional review of agency rulemaking.

Additionally, at least every 10 years, the Secretary in consultation with the Secretary of Commerce (*i.e.*, the Bureau of Economic Analysis),¹⁴² must submit a report to Congress analyzing the classification and assignment of all section 168 property, including the classification of assets as pooled property or real property, assignments of assets to pools, the number of asset pools, the applicable rates for such pools, and the recovery periods for straight-line property.

Business use

Business use percentage

In general, property used in a trade or business less than 50 percent of the time (“personal-use property”) is not eligible for depreciation.¹⁴³ For property used less than 100

¹³⁹ See section 13 of the discussion draft, Limitation on depreciation of personal use passenger automobiles, for a further discussion of personal-use automobiles.

¹⁴⁰ The first year the personal-use passenger automobile is placed in service is considered an entire year for purposes of the transition rule.

¹⁴¹ Unless otherwise noted, any reference to the “Secretary” means the Secretary of the Treasury.

¹⁴² It is expected that the Secretary of the Treasury will consult with the Bureau of Economic Analysis within the Commerce Department, which estimates economic depreciation for purposes of the National Income and Product Accounts. The purpose of these estimates is to measure the consumption of fixed capital for purposes of accurately measuring the components of gross domestic product.

¹⁴³ See section _14 of the discussion draft, Limitation on depreciation to property predominantly used in a trade or business, for new section 167(i).

percent of the time (but more than 50 percent of the time), the taxpayer is required to prorate the amount eligible for depreciation (*e.g.*, amount placed in service, amount added to the appropriate pool).¹⁴⁴

Conversion to personal use

In the case of any property used in a trade or business more than 50 percent of the time (“business-use property”) which is converted to personal-use property, the business-use property is treated as disposed of by the taxpayer at fair market value on the day of the conversion. A conversion to personal use results in the recapture of depreciation and gain, to the extent fair market value exceeds basis.¹⁴⁵ The option provides an exception to the general rule for any conversion to use as a principal residence.

Involuntary conversions

Under the option, if an involuntary conversion (as defined in section 1033) gives rise to gain (*e.g.*, negative pool balance), a taxpayer may defer the recognition of the gain to the end of the second tax year after the year of the involuntary conversion. Special transition rules apply for involuntary conversions where qualifying replacement property has not been placed in service as of the effective date.

The option applies to taxable years beginning after December 31, 2014.

Tax Reform Act of 2014 - Reform of Accelerated Cost Recovery System¹⁴⁶

Depreciation

In general

Under the option, the depreciation method for tangible property is the straight line method and the applicable recovery period generally is the class life of the property.¹⁴⁷ A recovery period is specifically assigned for the following property:

- Property with no class life (12 years);
- Any race horse, and any horse other than a race horse that is more than 12 years old at the time it is placed in service (3 years);
- Semi-conductor manufacturing equipment (5 years);

¹⁴⁴ *Ibid.*

¹⁴⁵ For pooled property, it is intended that the related party rules requiring the computation of a recomputed basis for the converted personal-use property apply. Authority is granted to the Secretary to provide rules for changes in the business use percentage between 50 percent and 100 percent.

¹⁴⁶ H.R. 1 (113th Cong.), introduced December 10, 2014, by then Chairman Dave Camp.

¹⁴⁷ See, *e.g.*, Rev. Proc. 87-56 (1987-2 C.B. 674) for class lives of certain property.

- Qualified technological equipment (5 years);
- Automobile or light general purpose truck (5 years);
- Qualified rent-to-own property (9 years);
- Certain telephone switching equipment (9.5 years);
- Railroad track (10 years);
- Smart electric distribution property (10 years);
- Airplanes (12 years);¹⁴⁸
- Natural gas gathering line (14 years);
- Tree or vine bearing fruit or nuts (20 years);
- Telephone distribution plant (24 years);
- Real property, including nonresidential real property and residential rental property (40 years);
- Water treatment and utility property (50 years);
- Clearing and grading improvements, and tunnel bore (50 years); and
- Tax-exempt use property subject to lease (recovery period shall be no less than 125 percent of the lease term).

Under the option, the Secretary is required to develop a schedule of class lives for all tangible property, except for property with a recovery period that was specifically assigned. One year following the delivery of the schedule of class lives, the revised class lives will take effect, replacing Revenue Procedure 87-56.

Inflation adjustment

The option provides an election for taxpayers to increase their depreciation deductions to take into account inflation. The election is made annually and applies to all property (except for specified property used outside the United States, real property, water treatment and utility property, and any clearing and grading land improvements or tunnel bore) placed in service during such taxable year.¹⁴⁹ With respect to property for which an election has been made, the taxpayer increases the depreciation deductions associated with such property by applying an inflation adjustment percentage to the modified adjusted basis of such property.¹⁵⁰ The term

¹⁴⁸ While the option increases the recovery period for fixed wing aircraft from six years to 12 years, the recovery period for helicopters remains unchanged from present law (*i.e.*, remains the six-year class life).

¹⁴⁹ Once elected, the taxpayer is required to apply the inflation adjustment percentage to such property for all subsequent taxable years.

¹⁵⁰ The increase for the first taxable year is reduced to take into account the placed in service convention applicable to the property (*i.e.*, reduced by one-eighth for property subject to the mid-quarter convention, and reduced by one-half for all other property).

“modified adjusted basis” means the taxpayer’s adjusted basis in such property determined as if the inflation adjustment had not been applied. The term “inflation adjustment percentage” means the cost-of-living adjustment for such calendar year, which is the percentage (if any) by which the Chained Consumer Price Index for all Urban Consumers (“C-CPI-U”)¹⁵¹ for the preceding calendar year exceeds the C-CPI-U for the second preceding calendar year. The overall depreciation allowance (including the inflation adjustment) for a taxable year with respect to any property may not exceed such property’s adjusted basis as of the beginning of such taxable year.

The below table illustrates depreciation for an asset with a cost of \$1,000 and a seven-year recovery period under the straight-line method using the half-year convention with and without the election to apply the inflation adjustment. For purposes of the inflation adjustment, an inflation rate of three percent is assumed in the below table.

Table 4.—Example

Year	Straight line method	Straight line with the inflation adjustment	Straight line beginning year basis	Adjusted basis end of year
1	71.40	86.40	1,000.00	913.60
2	142.90	170.76	928.60	742.84
3	142.90	166.47	785.70	576.37
4	142.80	162.08	642.80	414.29
5	142.90	157.90	500.00	256.39
6	142.80	153.51	357.10	102.87
7	142.90	102.87	214.30	0.00
8	71.40	0.00	71.40	0.00

Normalization

The option continues the rule that the tax benefits of public utility property may be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. In addition to requiring the normalization of depreciation deductions, the option provides for the normalization of excess deferred tax reserves resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before the date of enactment).

¹⁵¹ For a discussion of the indexing tax provisions for inflation, see the description of section 1001 of the discussion draft, “Simplification of individual income tax rates.”

If an excess deferred tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer will not be treated as using a normalization method of accounting with respect to any of its assets. Thus, if the excess deferred tax reserve is not normalized, the taxpayer must compute its depreciation allowances using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in regulated books of account.

The excess deferred tax reserve is the reserve for deferred taxes computed under prior law over what the reserve for deferred taxes would be if the tax rate in effect under the option had been in effect for all prior periods. The average rate assumption method is the method that reduces the excess deferred tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced as the timing differences (*i.e.*, differences between tax depreciation and regulatory depreciation with respect to each asset or group of assets in the case of vintage accounts) reverse over the life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. The excess deferred tax reserve is multiplied by a formula that is designed to insure that the excess is reduced to zero at the end of the regulatory life of the asset that generated the reserve.

The amendments made by this option apply to property placed in service after December 31, 2016.

F. Research Credit

Present Law

General rule

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.¹⁵² Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14-percent rate and a different base amount) may be claimed in lieu of this credit.¹⁵³

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.¹⁵⁴ This separate credit computation commonly is referred to as the basic research credit.

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.¹⁵⁵ This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2014.¹⁵⁶

Computation of general research credit

The general research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified

¹⁵² Sec. 41(a)(1). Except where otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

¹⁵³ Sec. 41(c)(5).

¹⁵⁴ Sec. 41(a)(2) and (e). The base period for the basic research credit generally extends from 1981 through 1983.

¹⁵⁵ Sec. 41(a)(3).

¹⁵⁶ Sec. 41(h).

research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).¹⁵⁷ In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

Alternative simplified credit

The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years.¹⁵⁸ The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.¹⁵⁹ An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.¹⁶⁰

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).¹⁶¹ Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

¹⁵⁷ The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

¹⁵⁸ Sec. 41(c)(5)(A).

¹⁵⁹ Sec. 41(c)(5)(B).

¹⁶⁰ Sec. 41(c)(5)(C).

¹⁶¹ Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

To be eligible for the credit, the research not only has to satisfy the requirements of section 174, but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.¹⁶² In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for internal use by the taxpayer; (6) conducted outside the United States, Puerto Rico, or any U.S. possession; (7) in the social sciences, arts, or humanities; or (8) funded by any grant, contract, or otherwise by another person (or government entity).¹⁶³

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.¹⁶⁴ Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.¹⁶⁵

Specified credits allowed against alternative minimum tax

For any taxable year, the general business credit (which is the sum of the various business credits) generally may not exceed the excess of the taxpayer's net income tax¹⁶⁶ over the greater of (1) the taxpayer's tentative minimum tax or (2) 25 percent of so much of the taxpayer's net regular tax liability¹⁶⁷ as exceeds \$25,000.¹⁶⁸ Any general business credit in excess of this limitation may be carried back one year and forward up to 20 years.¹⁶⁹ The tentative minimum

¹⁶² Sec. 41(d)(3).

¹⁶³ Sec. 41(d)(4).

¹⁶⁴ Sec. 280C(c).

¹⁶⁵ Sec. 280C(c)(3).

¹⁶⁶ The term "net income tax" means the sum of the regular tax liability and the alternative minimum tax, reduced by the credits allowable under sections 21 through 30D. Sec. 38(c)(1).

¹⁶⁷ The term "net regular tax liability" means the regular tax liability reduced by the sum of certain nonrefundable personal and other credits. Sec. 38(c)(1).

¹⁶⁸ Sec. 38(c)(1).

¹⁶⁹ Sec. 39(a)(1).

tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.¹⁷⁰ Generally, the tentative minimum tax of a C corporation with average annual gross receipts of less than \$7.5 million for prior 3-year periods is zero.¹⁷¹

In applying the tax liability limitation to a list of “specified credits” that are part of the general business credit, the tentative minimum tax is treated as being zero.¹⁷² Thus, the specified credits generally may offset both regular and alternative minimum tax liability (“AMT”).

For taxable years beginning in 2010, an eligible small business was allowed to offset both the regular and AMT liability with the general business credits determined for the taxable year (“eligible small business credits”).¹⁷³ For this purpose, an eligible small business was, with respect to any taxable year, a corporation, the stock of which was not publicly traded, a partnership, or a sole proprietor, if the average annual gross receipts did not exceed \$50 million.¹⁷⁴ Credits determined with respect to a partnership or S corporation were not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder met the gross receipts test for the taxable year in which the credits were treated as current year business credits.¹⁷⁵

Description of Options

Greater Research Opportunities With Tax Help Act (“GROWTH Act”)¹⁷⁶

This option makes permanent the alternative simplified method for calculating the research credit and increases the rate to 20 percent. That is, the research credit is equal to 20 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 10 percent if a taxpayer

¹⁷⁰ See sec. 55(b). For example, assume a taxpayer has a regular tax of \$80,000, a tentative minimum tax of \$100,000, and a research credit determined under section 41 of \$90,000 for a taxable year (and no other credits). Under present law, the taxpayer’s research credit is limited to the excess of \$100,000 over the greater of (1) \$100,000 or (2) \$13,750 (25% of the excess of \$80,000 over \$25,000). Accordingly, no research credit may be claimed (\$100,000 - \$100,000 = \$0) for the taxable year and the taxpayer’s net tax liability is \$100,000. The \$90,000 research credit may be carried back or forward under the rules applicable to the general business credit.

¹⁷¹ Sec. 55(e).

¹⁷² See section 38(c)(4)(B) for the list of specified credits, which does not presently include the research credit determined under section 41.

¹⁷³ Sec. 38(c)(5)(B).

¹⁷⁴ Sec. 38(c)(5)(C).

¹⁷⁵ Sec. 38(c)(5)(D).

¹⁷⁶ S. 1577 (112th Cong.), introduced September 19, 2011, by then Chairman Max Baucus.

has no qualified research expenses in any one of the three preceding taxable years. The option repeals the traditional 20-percent research credit calculation method.¹⁷⁷

The option is generally effective for taxable years beginning after December 31, 2011. The option to make the research credit permanent applies to amounts paid or incurred after December 31, 2011.

American Research and Competiveness Act of 2015¹⁷⁸

This option makes permanent the alternative simplified method for calculating the research credit and increases the rate to 20 percent. That is, the research credit is equal to 20 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 10 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. The option repeals the traditional 20-percent research credit calculation method.

The option also makes permanent the basic research credit and the energy research credit (both with credit rates of 20 percent), and changes the base period for the basic research credit from a fixed period to a three-year rolling average.

The option also provides that, in the case of an eligible small business (as defined in section 38(c)(5)(C)), the research credit is a specified credit. Thus, the research credits of an eligible small business may offset both regular and AMT liability.¹⁷⁹

The option is generally effective for taxable years beginning after December 31, 2014. The option to make the research credit permanent applies to amounts paid or incurred after December 31, 2014.

¹⁷⁷ The GROWTH Act also proposed certain technical amendments to section 41(f) regarding special rules for taxpayers under common control and the special rules for computing the research credit when a major portion of a trade or business (or unit thereof) changes hands. Such rules were subsequently modified by the American Taxpayer Relief Act of 2012 (Pub. L. No. 112-240).

¹⁷⁸ H.R. 880 (114th Cong.), introduced February 11, 2015, by Rep. Kevin Brady; passed House May 20, 2015. See also, H.R. Rep. No. 114-113.

¹⁷⁹ Using the above example, under this provision, the limitation would be the excess of \$80,000 over the greater of (1) \$0 or (2) \$13,750. Since \$13,750 is greater than \$0, the \$80,000 would be reduced by \$13,750 such that the research credit limitation would be \$66,250. Hence, the taxpayer would be able to claim a research credit of \$66,250 against its net income tax liability, as well as its AMT liability, which would result in \$33,250 of total tax owed (\$100,000 - \$66,250). The remaining \$23,750 of its research credit (\$90,000 - \$66,250) may be carried back or forward, as applicable.

President's fiscal year 2016 budget proposal¹⁸⁰

This option makes the research credit a permanent feature of the Code. However, for expenditures paid or incurred after 2015, the option repeals the traditional 20 percent research credit calculation method. In addition, the option increases the rate of the alternative simplified credit to 18 percent (*i.e.*, the research credit is equal to 18 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years), but does not reduce such rate if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

The option also allows the research credit to offset alternative minimum tax liability.

The option also changes the special rules in the research credit to allow, in certain cases, for contract research expenses to include 75 (instead of 65) percent of payments to qualified non-profit organizations (*e.g.*, educational institutions).

In addition, the option repeals the special rule for pass-through entities which limits the pass-through of the research credit to each owner's tax on income allocable to its ownership interest.

Finally, the option repeals the requirement that an individual owner of a pass-through entity who does not materially participate in such business must capitalize and amortize section 174(a) research and experimental expenditures over 10 years when calculating alternative minimum tax liability.

The option is effective for expenditures paid or incurred after December 31, 2015.

¹⁸⁰ As submitted to the Congress on February 2, 2015. See Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2016: Analytical Perspectives (H. Doc. 114-3, Vol. III), February 2, 2015, pp. 149-204.

G. Publicly Traded Partnership Rules

Present Law

Partnerships in general

A partnership generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a passthrough entity. Income earned by a partnership, whether distributed or not, is taxed to the partners.¹⁸¹ The character of partnership items passes through to the partners, as if the items were realized directly by the partners.¹⁸²

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.¹⁸³ A corporation is subject to tax at the corporate level on its taxable income.¹⁸⁴ For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).¹⁸⁵ As of the first day that a partnership is treated as a corporation, the partnership is treated for Federal tax purposes as transferring all its assets (subject to liabilities) to a newly formed corporation in exchange for the stock of the corporation, and distributing the stock to its partners in liquidation of their partnership interests.¹⁸⁶

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.¹⁸⁷ Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of

¹⁸¹ Sec. 701.

¹⁸² Sec. 702.

¹⁸³ Sec. 7704(a).

¹⁸⁴ Sec. 11(a).

¹⁸⁵ Sec. 7704(b).

¹⁸⁶ Sec. 7704(f).

¹⁸⁷ Sec. 7704(c)(2).

partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

Description of Option

Master Limited Partnerships Parity Act¹⁸⁸

The option proposed in the Master Limited Partnership Parity Act expands the types of income that publicly traded partnerships may earn without being taxed as a corporation under section 7704. In particular, the option expands the definition of qualifying income to include income generated from certain: (1) renewable power facilities (that produce electricity using resources such as wind, solar, or biomass), (2) electricity storage devices (i.e. utility-scale batteries), (3) combined heat and power facilities, (4) renewable thermal energy projects (similar to renewable power, but where the income is derived from selling heat rather than electricity), (5) waste-heat-to-power projects, (6) renewable fuel infrastructure projects, (7) renewable fuels, (8) renewable chemicals, (9) energy efficient commercial buildings, (10) gasification projects (as defined in section 48B(c)(1)(A) and (B)) that sequester at least 75 percent of their qualified carbon dioxide, and (11) carbon dioxide capture and sequestration (using definitions set forth in section 45Q).

Effective Date

The option would be effective on the date of enactment.

¹⁸⁸ S. 1656 (114th Cong.), introduced June 24, 2015, by Senator Coons and cosponsored by Senators Moran, Murkowski, Stabenow, Collins, Bennet, Gardner, and King.

H. Tax Return Due Date Simplification

Present Law

Persons required to file income tax returns¹⁸⁹ must file such returns in the manner prescribed by the Secretary, in compliance with due dates established in the Code, if any, or by regulations. The Code includes a general rule that requires income tax returns to be filed on or before the 15th day of the fourth month following the end of the taxable year, but certain exceptions are provided both in the Code and in regulations.

A partnership generally is required to file a Federal income tax return on or before the 15th day of the fourth month after the end of the partnership taxable year.¹⁹⁰ For a partnership with a taxable year that is a calendar year, for example, the partnership return due date (and the date by which Schedules K-1 must be furnished to partners) is April 15. However, a partnership is allowed an automatic five-month extension of time to file the partnership return and the Schedule K-1s (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.¹⁹¹

A C corporation or an S corporation generally is required to file a Federal income tax return on or before the 15th day of the third month following the close of the corporation's taxable year. For a corporation with a taxable year that is a calendar year, for example, the corporate return due date is March 15.¹⁹² However, a corporation is allowed an automatic six-month extension of time to file the corporate return (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.¹⁹³

¹⁸⁹ Section 6012 provides general rules identifying who must file an income tax return, while other Code provisions referenced herein specifically address filing requirements of partnerships, corporations, and other entities.

¹⁹⁰ Secs. 6031, 6072.

¹⁹¹ Sec. 6081. Treas. Reg. sec. 1.6081-2. See Department of the Treasury, Internal Revenue Service, *2011 Instructions for Form 1065, U.S. Return of Partnership Income*, p. 3. Unlike other partnerships, an electing large partnership is required to furnish a Schedule K-1 to each partner by the first March 15 following the close of the partnership's taxable year (sec. 6031(b)). For calendar year 2012 partnerships, for example, the due date is March 15, 2013 even though the partnership return due date is April 15, 2013. However, an electing large partnership is allowed an automatic six-month extension of time to file the partnership return and the Schedule K-1s by submitting an application on form 7004 in accordance with the rules prescribed by the Treasury Regulations. Treas. Reg. sec. 1.6081-2(a)(2).

¹⁹² Secs. 6012, 6037, 6072. Section 6012(a)(2) provides that every corporation subject to taxation under subtitle A shall be required to file an income tax return. Section 6037, which governs the returns of S corporations, provides that any return filed pursuant to section 6037 shall, for purposes of chapter 66 (relating to limitations) be treated as a return filed by the corporation under section 6012. Section 6072, which sets forth the due dates for filing various income tax returns, provides that returns of corporations with a taxable year that is a calendar year under section 6012 (and section 6037 based on the language in that section) are due March 15.

¹⁹³ Section 6081(b) provides that a corporation is allowed an automatic extension of three months to file its income tax return if the corporation files the form prescribed by the Secretary and pays on or before the due date prescribed for payment, the amount properly estimated as its tax. However, section 6081(a) provides that the

To assist taxpayers in preparing their income tax returns and to help the Internal Revenue Service (“IRS”) determine whether such income tax returns are correct and complete, present law imposes a variety of information reporting requirements on participants in certain transactions.¹⁹⁴ The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments aggregating \$600 or more in any taxable year to a single payee in the course of the payor’s trade or business.¹⁹⁵ Payments subject to reporting include fixed or determinable income or compensation, but do not include payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements.¹⁹⁶ Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock) paid to U.S. persons.¹⁹⁷

The payor of amounts described above is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.¹⁹⁸ The statement must be supplied to taxpayers by the payors by January 31 of the year following the calendar year for which the return must be filed. Payors generally must file the information return with the IRS on or before the last day of February of the year following the calendar year for which the return must be filed,¹⁹⁹ unless they file electronically, in which event the information returns are due March 31.²⁰⁰

Payors also must report wage amounts paid to employees on information returns. For wages paid to, and taxes withheld from, employees, the payors must file an information return with the Social Security Administration (“SSA”) by February 28 of the year following the

Secretary may grant an automatic extension of up to six months to file and the Treasury regulations do so provide. Treas. Reg. sec. 1.6081-3.

¹⁹⁴ Secs. 6031 through 6060.

¹⁹⁵ Sec. 6041(a). The information return generally is submitted electronically as a Form-1099 or Form-1096, although certain payments to beneficiaries or employees may require use of Forms W-3 or W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2).

¹⁹⁶ Sec. 6041(a) requires reporting as to fixed or determinable gains, profits, and income (other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a), or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045). These payments excepted from section 6041(a) include most interest, royalties, and dividends.

¹⁹⁷ Secs. 6042 (dividends), 6045 (broker reporting) and 6049 (interest) and the Treasury regulations thereunder.

¹⁹⁸ Sec. 6041(d).

¹⁹⁹ Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

²⁰⁰ Secs. 6011(e) and 6071(b) apply to “returns made under subparts B and C of part III of this subchapter”; Treas. Reg. sec. 301.6011-2(b), mandates use of magnetic media by persons filing information returns identified in the regulation or subsequent or contemporaneous revenue procedures and permits use of magnetic media for all others.

calendar year for which the return must be filed.²⁰¹ However, the due date for information returns that are filed electronically is March 31.

Under the combined annual wage reporting (“CAWR”) system, the SSA and the IRS have an agreement, in the form of a Memorandum of Understanding, to share wage data and to resolve, or reconcile, the differences in the wages reported to them. Employers submit Forms W-2, Wage and Tax Statement (listing Social Security wages earned by individual employees), and W-3, Transmittal of Wage and Tax Statements (providing an aggregate summary of wages paid and taxes withheld) directly to SSA.²⁰² After it records the Forms W-2 and W-3 wage information in its individual Social Security wage account records, SSA forwards the Forms W-2 and W-3 information to IRS.²⁰³

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an account with a foreign financial agency.²⁰⁴ Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act²⁰⁵ provide additional guidance regarding the disclosure obligation with respect to foreign accounts. Treasury Department Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts,” (the “FBAR”) must be filed by June 30 of the year following the year in which the \$10,000 filing threshold is met.²⁰⁶

²⁰¹ Treas. Reg. sec. 31.6051-2; IRS, “Filing Information Returns Electronically,” Pub. 3609 (Rev. 12-2011); Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

²⁰² Pub. L. No. 94-202, sec. 232, 89 Stat. 1135 (1976) (effective with respect to statements reporting income received after 1977).

²⁰³ Employers submit quarterly reports to IRS on Form 941 regarding aggregate quarterly totals of wages paid and taxes due. IRS then compares the W-3 wage totals to the Form 941 wage totals.

²⁰⁴ 31 U.S.C. sec. 5314. The term “agency” in the Bank Secrecy Act includes financial institutions.

²⁰⁵ 31 U.S.C. sec. 5314(a) provides: “Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.”

²⁰⁶ 31 C.F.R. sec. 103.27(c). The \$10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

Description of Option

Tax Return Due Date Simplification and Modernization Act of 2013²⁰⁷

This option includes the following features: (i) filing deadline for partnerships and S corporations precede the due dates of their individual and corporate investors and (ii) due date for filing returns by C corporations to be determined under general rule, with effect that it is a later return than under present law. It also includes statutory confirmation that six-month extension for time to file corporate income tax return is automatic, conforms the FBAR filing due date with income tax filing dates, and requires regulatory updates to the rules regarding extension of time to file a return.

Filing deadlines for business income tax returns

The option accelerates the due date for filing of Federal income tax returns of partnerships, and removes C corporations from the scope of the exception to the general rule that requires income tax returns to be filed by the 15th day of the fourth month after the end of a taxable year. It also moves the due date for returns filed by S corporations from the 15th to the 30th of the third month following the close of the year.

The option requires that the C corporation return be filed on or before the 15th day of the fourth month after the close of a taxable year, or April 15 in the case of a calendar year taxpayer.

Extensions of time to file tax returns

The option modifies the statute to provide (consistent with current Treasury regulations) that a corporation is allowed an automatic six-month extension of time to file its Federal corporate income tax return (to October 15 for a calendar year taxpayer, assuming the new filing dates as described in section 6201 above) if the corporation files the form prescribed by the Secretary and pays on or before the due date prescribed for payment, the amount properly estimated as its tax.

The option requires that the Treasury Department modify its regulations that establish extensions of due dates by conforming the extension periods to the following terms. The maximum extension for the returns of partnerships using a calendar year is a six-month period ending on September 15. The maximum extension for the returns of trusts using a calendar year is a 5-1/2 month period ending on September 30. The maximum extension for the returns of employee benefit plans using a calendar year is an automatic 3-1/2 month period ending on November 15. The maximum extension for the returns of tax-exempt organizations using a calendar year is an automatic six-month period ending on November 15. The due date for forms relating to the Annual Information Return of Foreign Trust with a United States Owner for calendar year filers is April 15 with a maximum extension for a six-month period ending on October 15.

²⁰⁷ The “Tax Return Due Date Simplification and Modernization Act of 2013,” (S. 420, 113th Cong.), introduced by Senator Enzi.

FBAR due date conformity with income tax filing

In addition to requiring modification of the regulatory deadlines established for extensions of time to file income tax returns, the option establishes a statutory due date for the form required under FBAR that generally conforms to income tax filing deadlines. Under the option, the FBAR due date is April 15 with regulatory authority to grant an extension of up to a six-month period ending on October 15. The option permits the Secretary to waive any penalties for failure to file a timely request for an extension if the reporting period to which the penalty relates is the first period for which the taxpayer was subject to the FBAR requirements.

I. Mandatory E-filing by Exempt Organizations

Present Law

In general

The Internal Revenue Service Restructuring and Reform Act of 1998 (“RRA 1998”)²⁰⁸ states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007.²⁰⁹ Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

Present law requires the Secretary to issue regulations regarding electronic filing and specifies certain limitations on the rules that may be included in such regulations.²¹⁰ The statute requires that Federal income tax returns prepared by specified tax return preparers be filed electronically,²¹¹ and that all partnerships with more than 100 partners be required to file electronically. For taxpayers other than partnerships, the statute prohibits any requirement that persons who file fewer than 250 returns during a calendar year file electronically. With respect to individuals, estates, and trusts, the Secretary may permit, but generally cannot require, electronic filing of income tax returns. In crafting any of these required regulations, the Secretary must take into account the ability of taxpayers to comply at reasonable cost.

The regulations require corporations that have assets of \$10 million or more and file at least 250 returns during a calendar year to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. In determining whether the 250 return threshold is met, income tax, information, excise tax, and employment tax returns filed within one calendar year are counted.

Tax-exempt organizations

Most tax-exempt organizations are required to file annual information returns in the Form 990 series. Since 2007, the smallest organizations – generally, those with gross receipts of less than \$50,000 – may provide an abbreviated notice on Form 990-N, sometimes referred to as an “e-postcard.” Which form to file depends on the annual receipts, value of assets, and types of activities of the exempt entity. The Forms 990, 990-EZ, and 990-PF are released to the public on DVDs.

²⁰⁸ Pub. L. No. 105-206.

²⁰⁹ The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, page 6.

²¹⁰ Sec. 6011(e).

²¹¹ Section 6011(e)(3)(B) defines a “specified tax return preparer” as any return preparer who reasonably expects to file more than 10 individual income tax returns during a calendar year.

In general, only the largest and smallest tax-exempt organizations are required to electronically file their annual information returns. First, as indicated above, tax-exempt corporations that have assets of \$10 million or more and that file at least 250 returns during a calendar year must electronically file their Form 990 information returns. Private foundations and charitable trusts, regardless of asset size, that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns.²¹² Finally, organizations that file Form 990-N (the e-postcard) also must electronically file.²¹³

Description of Option²¹⁴

The option extends the requirement to e-file to all tax-exempt organizations required to file statements or returns in the Form 990 series. The option also requires that the IRS make the information provided on the forms available to the public in a machine-readable format as soon as practicable. It is intended that the information be provided to the public in a format that permits one to extract and perform computations on the data but not alter or manipulate the statements or returns from which the data is to be extracted.

Effective Date

The option generally is effective for taxable years beginning after date of enactment. Transition relief is provided for certain organizations. First, for certain small organizations or other organizations for which the Secretary determines that application of the e-filing requirement would constitute an undue hardship in the absence of additional transitional time, the requirement to file electronically must be implemented not later than taxable years beginning two years following the date of enactment. For this purpose, small organization means any organization: (1) the gross receipts of which for the taxable year are less than \$200,000; and (2) the aggregate gross assets of which at the end of the taxable year are less than \$500,000. In addition, the proposal grants IRS the discretion to delay the effective date not later than taxable years beginning two years after the date of enactment for the filing of form 990-T (reports of unrelated business taxable income or the payment of proxy tax under section 6033(e)).

²¹² Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer.

²¹³ See Form 990-N, “Electronic Notice for Tax-exempt Organizations not Required to File a Form 990 or 990-EZ.”

²¹⁴ See the Taxpayer Bill of Rights Enhancement Act of 2015 (S. 1578, 114th Cong.), sec. 504. An identical proposal is included in the Tax Reform Act of 2014 (H.R. 1, 113th Cong), sec. 6004, introduced by then-Ways and Means Committee Chairman Camp. A similar proposal is included in the Administration's budget proposals for each of fiscal years 2014 through 2016. See, e.g., Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2015 Revenue Proposals* (March 2014), p. 231. For fiscal year 2016, the Administration's proposal is combined with proposed e-filing requirements for other types of taxpayers. See Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals* (March 2014), pp. 247-249.

J. Declaratory Judgment Procedure Extended to All Organizations Exempt from Tax Under Section 501(c) or 501(d)

Present Law

Tax exemption for section 501(c) and (d) organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Recognition of exempt status

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it must file an application for recognition of exemption with the IRS and receive a favorable determination of its status.²¹⁵ For most section 501(c)(3) organizations, eligibility to receive tax-deductible contributions similarly is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases where an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS generally may revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

Many other types of organizations exempt from tax under section 501(c) may, but are not required to, file an application for recognition of exempt status. This includes organizations described in sections of 501(c)(4) (social welfare and certain other organizations), 501(c)(5) (labor and horticultural organizations), and 501(c)(6) (business leagues, trade associations, etc.).

Declaratory judgment procedure

Present law authorizes an organization to seek a declaratory judgment regarding its tax-exempt status as a remedy if the IRS denies its application for recognition of exemption under section 501(c)(3), fails to act on such an application, or informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status.²¹⁶ The right to seek a declaratory judgment arises in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a

²¹⁵ Sec. 508(a).

²¹⁶ Sec. 7428.

private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3).²¹⁷ A “determination” in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.²¹⁸

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS.²¹⁹ For the first 270 days after a request for a determination is made and before the IRS informs the organization of its decision, an organization is deemed not to have exhausted its administrative remedies. If no determination is made during the 270-day period, the organization may initiate an action for declaratory judgment after the period has elapsed. If, however, the IRS makes an adverse determination during the 270-day period, an organization may immediately seek declaratory relief. The 270-day period does not begin with respect to applications for recognition of tax-exempt status until the date a substantially completed application is submitted.

Under present law, a non-charity (*i.e.*, an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. In general, such an organization must petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or pay any tax owed and file a refund action in Federal district court or the U.S. Court of Federal Claims.

Description of Option²²⁰

The option extends the section 7428 declaratory judgment procedure to the initial determination or continuing classification of an organization as tax-exempt under section 501(a) as an organization described in section 501(d) (religious and apostolic organizations) or any subsection of section 501(c) (including, for example, section 501(c)(4) (social welfare and certain other organizations), 501(c)(5) (labor and horticultural organizations), and 501(c)(6) (trade associations, business leagues, etc.)).

The option also modifies section 7428 with regard to the court or courts from which an organization may seek a declaratory judgment. Under the option, an organization may seek a declaratory judgment from the U.S. Tax Court in the case of any type of determination or failure to which the declaratory judgment rules apply. An organization may seek a declaratory judgment from the U.S. Court of Federal Claims or the U.S. District Court for the District of Columbia, however, only in the case of determinations or failures relating to: (1) the initial

²¹⁷ Sec. 7428(a)(1).

²¹⁸ Sec. 7428(a)(2).

²¹⁹ Sec. 7428(b)(2).

²²⁰ See the Taxpayer Bill of Rights Enhancement Act of 2015 (S. 1578, 114th Cong.), sec. 303. A more limited proposal that extends the section 501(c)(3) declaratory judgment procedure only to section 501(c)(4) organizations and which does not modify the rules regarding courts of jurisdiction is included in the Tax Reform Act of 2014 (H.R. 1, 113th Cong.), sec. 6002, introduced by then-Ways and Means Committee Chairman Camp.

qualification or continuing of an organization as an organization described in section 501(c)(3) or 170(c)(2); (2) the initial qualification or continuing classification of an organization as a private foundation (as defined in section 509(a)) or a private operating foundation (as defined in section 4942(j)(3)); or (3) the initial classification or continuing classification of a cooperative as an organization described in section 521(b).

Effective Date

The option is effective for pleadings filed after the date of enactment.

K. Simplification of Excise Tax on Private Foundation Net Investment Income

Present Law

Excise tax on the net investment income of private foundations

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations) are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)²²¹ equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.²²² In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.²²³

Exempt operating foundations

Exempt operating foundations are exempt from the tax on the net investment income of private foundations.²²⁴ Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined

²²¹ Sec. 4942(g).

²²² Sec. 4940(e).

²²³ Sec. 4942(d)(2).

²²⁴ Sec. 4940(d)(1).

in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons.²²⁵

Description of Option²²⁶

The option replaces the two rates of excise tax on tax-exempt private foundations with a single rate of tax of one percent. Thus, under the proposal, a tax-exempt private foundation generally is subject to an excise tax of one percent on its net investment income. A taxable private foundation is subject to an excise tax equal to the excess (if any) of the sum of the one-percent net investment income excise tax and the amount of the tax on unrelated business income (both calculated as if the foundation were tax-exempt), over the income tax imposed on the foundation. The proposal repeals the special reduced excise tax rate for private foundations that exceed their historical level of qualifying distributions.

Effective Date

The option is effective for taxable years beginning after the date of enactment.

²²⁵ Sec. 4940(d)(2).

²²⁶ See the America Gives More Act of 2015 (S. 644, 114th Cong.), sec. 5, as passed by the U.S. House of Representatives on February 12, 2015. A similar proposal (effective for taxable years beginning after December 31, 2014) is included in the Tax Reform Act of 2014 (H.R. 1, 113th Cong), sec. 5204, although that proposal also repeals the exception for exempt operating foundations from the tax on net investment income of private foundations. A similar proposal also is included in the Administration's budget proposals for fiscal years 2016, although the Administration's proposal sets the excise tax rate at 1.35 percent. Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals* (March 2014), p. 267.