

**DESCRIPTION OF THE CHAIRMAN’S MARK OF THE  
“EXPIRING PROVISIONS IMPROVEMENT REFORM  
AND EFFICIENCY (EXPIRE) ACT”**

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## INTRODUCTION

The Senate Committee on Finance has scheduled a markup of the “Expiring Provisions Improvement Reform and Efficiency (EXPIRE) Act.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman’s mark with respect to expiring tax provisions.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman’s Mark of the “Expiring Provisions Improvement Reform and Efficiency (EXPIRE) Act”* (JCX-26-14), April 1, 2014. This document may also be found on our website at [www.jct.gov](http://www.jct.gov)

## TITLE I – PROVISIONS EXPIRING IN 2013

### A. Individual Tax Extenders

#### 1. Deduction for certain expenses of elementary and secondary school teachers (sec. 62(a)(2)(D) of the Code)

##### Present Law

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. For taxable years beginning after 2012, an individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2014, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.<sup>2</sup> To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education (kindergarten through grade 12), as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2013.

##### Description of Proposal

The proposal extends the deduction for eligible educator expenses for two years, through December 31, 2015.

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<sup>2</sup> Sec. 62(a)(2)(D).

## Effective Date

The proposal applies to taxable years beginning after December 31, 2013.

## **2. Exclude discharges of acquisition indebtedness on principal residences from gross income (sec. 108 of the Code)**

### Present Law

#### In general

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108).<sup>3</sup> In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge (sec. 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

#### Qualified principal residence indebtedness

An exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of section 163(h)(3)(B), except that the dollar limitation is \$2 million) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under section 121 of the Code.

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<sup>3</sup> A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold for \$700,000 and \$300,000 debt is discharged, then only \$100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The basis of the individual's principal residence is reduced by the amount excluded from income under the provision.

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2014.

### **Description of Proposal**

The proposal extends for two additional years (through December 31, 2015) the exclusion from gross income for discharges of qualified principal residence indebtedness.

### **Effective Date**

The proposal applies to discharges of indebtedness on or after January 1, 2014.

## **3. Parity for exclusion from income for employer-provided mass transit and parking benefits (sec. 132(f) of the Code)**

### **Present Law**

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income for income tax purposes and from an employee's wages for employment tax purposes.<sup>4</sup> Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement). Qualified transportation fringe benefits also include a cash

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<sup>4</sup> Secs. 132(a)(5) and (f), 3121(a)(20), 3231(e)(5), 3306(b)(16) and 3401(a)(19).

reimbursement (under a bona fide reimbursement arrangement) by an employer to an employee for parking, transit passes, or vanpooling. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Before February 17, 2009, the amount that could be excluded as qualified transportation fringe benefits was limited to \$100 per month in combined transit pass and vanpool benefits and \$175 per month in qualified parking benefits. These limits are adjusted annually for inflation, using 1998 as the base year; for 2014, the limits are \$130 and \$250, respectively. Effective for months beginning on or after February 17, 2009,<sup>5</sup> and before January 1, 2014, parity in qualified transportation fringe benefits is provided by temporarily increasing the monthly exclusion for combined employer-provided transit pass and vanpool benefits to the same level as the exclusion for employer-provided parking.

Effective January 1, 2014, the amount that can be excluded as qualified transportation fringe benefits is limited to \$130 per month in combined transit pass and vanpool benefits and \$250 per month in qualified parking benefits.

### **Description of Proposal**

The proposal extends parity in qualified transportation fringe benefits for two years through December 31, 2015. Thus, for 2014, the monthly limit on the exclusion for combined transit pass and vanpool benefits is \$250, the same as the monthly limit on the exclusion for qualified parking benefits.

### **Effective Date**

The proposal applies to months after December 31, 2013.

## **4. Mortgage insurance premiums (sec. 163 of the Code)**

### **Present Law**

#### **In general**

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

#### **Acquisition indebtedness and home equity indebtedness**

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum

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<sup>5</sup> Parity was originally provided by the American Recovery and Reinvestment Act of 2009 (“ARRA”), Pub. L. No. 111-5, effective for months beginning on or after February 17, 2009, the date of enactment of ARRA.



amount of home equity indebtedness is \$100,000. The maximum amount of acquisition indebtedness is \$1 million. Acquisition indebtedness means debt that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

### **Private mortgage insurance**

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each \$1,000 by which the taxpayer's adjusted gross income exceeds \$100,000 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds \$110,000 (\$55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration,<sup>6</sup> and private mortgage insurance (defined in section two of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2013, or properly allocable to any period after that date.

Reporting rules apply under the provision.

### **Description of Proposal**

The proposal extends the deduction for private mortgage insurance premiums for two years (with respect to contracts entered into after December 31, 2006). Thus, the proposal applies to amounts paid or accrued in 2014 and 2015 (and not properly allocable to any period after 2015).

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<sup>6</sup> The Veterans Administration and the Rural Housing Administration have been succeeded by the Department of Veterans Affairs and the Rural Housing Service, respectively.

## Effective Date

The proposal applies to amounts paid or accrued after December 31, 2013.

### **5. Deduction for State and local sales taxes (sec. 164 of the Code)**

#### Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning before 2014, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats, and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

A general sales tax is a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.<sup>7</sup> No deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of food, clothing, medical supplies, and motor vehicles, the above rules are relaxed in two ways. First, if the tax does not apply with respect to some or all of such items, a tax that applies to other such items can still be considered a general sales tax. Second, the rate of tax applicable with respect to some or all of these items may be lower than the general rate. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess is disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

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<sup>7</sup> Sec. 164(b)(5)(B).

## Description of Proposal

The proposal extends the provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes for two years, through 2015.

### Effective Date

The proposal applies to taxable years beginning after December 31, 2013.

## **6. Deduction for qualified tuition and related expenses (sec. 222 of the Code)**

### Present Law

An individual is allowed a deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.<sup>8</sup> The deduction is allowed in computing adjusted gross income. The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.<sup>9</sup> The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2013.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,<sup>10</sup> and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay

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<sup>8</sup> Sec. 222.

<sup>9</sup> The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

<sup>10</sup> Secs. 222(d)(1) and 25A(g)(2).

higher education tuition and fees; and (2) income from a Coverdell education savings account.<sup>11</sup> Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

### **Description of Proposal**

The proposal extends the qualified tuition deduction for two years, through 2015.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2013.

## **7. Tax-free distributions from individual retirement plans for charitable purposes (sec. 408(d)(8) of the Code)**

### **Present Law**

#### **In general**

If an amount withdrawn from a traditional individual retirement arrangement (“IRA”) or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

#### **Charitable contributions**

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to the following entities: (1) a charity described in section 170(c)(2); (2) certain veterans’ organizations, fraternal societies, and cemetery companies;<sup>12</sup> and (3) a Federal, State, or local governmental entity, but only if the contribution is made for exclusively public purposes.<sup>13</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

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<sup>11</sup> Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

<sup>12</sup> Secs. 170(c)(3)-(5).

<sup>13</sup> Sec. 170(c)(1).

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>14</sup>

A taxpayer who takes the standard deduction (*i.e.*, who does not itemize deductions) may not take a separate deduction for charitable contributions.<sup>15</sup>

A payment to a charity (regardless of whether it is termed a “contribution”) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service provided) to the taxpayer in consideration for the contribution.<sup>16</sup> In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.<sup>17</sup>

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations generally may not exceed 50 percent of the taxpayer’s contribution base, which is the taxpayer’s adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer’s contribution base, (2) contributions of cash to most private nonoperating foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer’s contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer’s contribution base.

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<sup>14</sup> Secs. 170(b) and (e).

<sup>15</sup> Sec. 170(a).

<sup>16</sup> Sec. 170(f)(8). For any contribution of a cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. Sec. 170(f)(17).

<sup>17</sup> Sec. 6115.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits generally may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (*e.g.*, a remainder) while also either retaining an interest in that property (*e.g.*, an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.<sup>18</sup> Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.<sup>19</sup> For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

### **IRA rules**

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Certain individuals also may make nondeductible contributions to a Roth IRA (deductible contributions cannot be made to Roth IRAs). Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by April 1 of the calendar year following the year in which the IRA owner attains age 70-½.<sup>20</sup>

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

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<sup>18</sup> Secs. 170(f), 2055(e)(2), and 2522(c)(2).

<sup>19</sup> Sec. 170(f)(2).

<sup>20</sup> Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;<sup>21</sup> (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.<sup>22</sup> Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

### **Qualified charitable distributions**

Otherwise taxable IRA distributions from a traditional or Roth IRA are excluded from gross income to the extent they are qualified charitable distributions.<sup>23</sup> The exclusion may not exceed \$100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½ and only to the extent the distribution would be includible in gross income (without regard to this provision).

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the

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<sup>21</sup> Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

<sup>22</sup> Sec. 3405.

<sup>23</sup> Sec. 408(d)(8). The exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (“SEPs”).

donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under section 170.

Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2013.

#### **Description of Proposal**

The proposal extends the exclusion from gross income for qualified charitable distributions from an IRA for two additional years, *i.e.*, for distributions made in taxable years beginning before January 1, 2016.

#### **Effective Date**

The proposal is effective for distributions made in taxable years beginning after December 31, 2013.



## **B. Business Tax Extenders**

### **1. Research credit (sec. 41 of the Code)**

#### **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.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup> This separate credit computation commonly is referred to as the basic research credit.<sup>27</sup>

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.<sup>28</sup> 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, 2013.<sup>29</sup>

##### **Computation of allowable credit**

Except for energy research payments, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. In general, 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

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<sup>24</sup> Sec. 41(a)(1).

<sup>25</sup> Sec. 41(c)(5).

<sup>26</sup> Sec. 41(a)(2).

<sup>27</sup> Sec. 41(e).

<sup>28</sup> Sec. 41(a)(3).

<sup>29</sup> Sec. 41(h).

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 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).<sup>30</sup> In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses. Slightly different rules apply in calculating the basic research credit, which generally has a base period that extends from 1981 through 1983.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.<sup>31</sup> Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.<sup>32</sup>

### **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.<sup>33</sup> The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.<sup>34</sup> An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.<sup>35</sup>

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<sup>30</sup> 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).

<sup>31</sup> Sec. 41(f)(1).

<sup>32</sup> Sec. 41(f)(3).

<sup>33</sup> Sec. 41(c)(5)(A).

<sup>34</sup> Sec. 41(c)(5)(B).

<sup>35</sup> Sec. 41(c)(5)(C).

## **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).<sup>36</sup> 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.

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.<sup>37</sup> 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).<sup>38</sup>

## **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

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<sup>36</sup> 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).

<sup>37</sup> Sec. 41(d)(3).

<sup>38</sup> Sec. 41(d)(4).

year.<sup>39</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>40</sup>

### **Description of Proposal**

The proposal extends the research credit for two years (through 2015).

### **Effective Date**

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

## **2. Extension of temporary minimum low-income housing tax credit rate for non-Federally subsidized new buildings (sec. 42 of the Code)**

### **Present Law**

#### **In general**

The low-income housing credit may be claimed over a 10-year credit period after each low-income building is placed-in-service. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building.

#### **Present value credit**

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not Federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is Federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not Federally subsidized) are eligible for the 70-percent credit.

#### **Calculation of the applicable percentage**

##### **In general**

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a

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<sup>39</sup> Sec. 280C(c).

<sup>40</sup> Sec. 280C(c)(3).

credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

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

#### Special rule

Under this rule the applicable percentage is set at a minimum of 9 percent for newly constructed non-Federally subsidized buildings placed in service after July 30, 2008, and before January 1, 2014.

#### **Description of Proposal**

The provision extends the temporary minimum applicable percentage of 9 percent for newly constructed non-Federally subsidized buildings with respect to which credit allocations are made before January 1, 2016.

#### **Effective Date**

The provision is effective on January 1, 2014.

### **3. Extension of military housing allowance exclusion for determining area median gross income (secs. 42 and 142 of the Code)**

#### **Present Law**

#### **In general**

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project that satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of the residential units in the project are both rent-restricted, and occupied by individuals whose income is 50 percent or less of area median gross income (the “20-50 test”). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted, and occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”). These income figures are adjusted for family size.

#### **Rule for income determinations before July 30, 2008 and on or after January 1, 2014**

The recipients of the military basic housing allowance must include these amounts for purposes of low-income credit eligibility income test, as described above.

### **Special rule for income determination before January 1, 2014**

Under the provision the basic housing allowance (*i.e.*, payments under 37 U.S.C. sec. 403) is not included in income for the low-income credit income eligibility rules. The provision is limited in application to qualified buildings. A qualified building is defined as any building located:

1. any county which contains a qualified military installation to which the number of members of the Armed Forces assigned to units based out of such qualified military installation has increased by 20 percent or more as of June 1, 2008, over the personnel level on December 31, 2005; and
2. any counties adjacent to a county described in (1), above.

For these purposes, a qualified military installation is any military installation or facility with at least 1000 members of the Armed Forces assigned to it.

The provision applies to income determinations: (1) made after July 30, 2008, and before January 1, 2014, in the case of qualified buildings which received credit allocations on or before July 30, 2008, or qualified buildings placed in service on or before July 30, 2008, to the extent a credit allocation was not required with respect to such building by reason of 42(h)(4) (*i.e.*, such qualified building was at least 50 percent tax-exempt bond financed with bonds subject to the private activity bond volume cap) but only with respect to bonds issued before July 30, 2008; and (2) made after July 30, 2008, in the case of qualified buildings which received credit allocations after July 30, 2008 and before January 1, 2014, or qualified buildings placed in service after July 30, 2008, and before January 1, 2014, to the extent a credit allocation was not required with respect to such qualified building by reason of 42(h)(4) (*i.e.*, such qualified building was at least 50 percent tax-exempt bond financed with bonds subject to the private activity bond volume cap) but only with respect to bonds issued after July 30, 2008, and before January 1, 2014.

### **Description of Proposal**

The provision extends the special rule two additional years (through December 31, 2015).

### **Effective Date**

The provision is effective for income determinations on or after January 1, 2014.

## **4. Indian employment tax credit (sec. 45A of the Code)**

### **Present Law**

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the

employer with respect to certain employees.<sup>41</sup> The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974<sup>42</sup> or section 4(10) of the Indian Child Welfare Act of 1978.<sup>43</sup> For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjusted for inflation is \$45,000 for 2013). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years that begin on or before December 31, 2013.

### **Description of Proposal**

The proposal extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2015).

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<sup>41</sup> Sec. 45A.

<sup>42</sup> Pub. L. No. 93-262.

<sup>43</sup> Pub. L. No. 95-608.

## Effective Date

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

### **5. New markets tax credit (sec. 45D of the Code)**

#### Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (“CDE”).<sup>44</sup> The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.<sup>45</sup> The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.<sup>46</sup> The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed.<sup>47</sup>

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE.<sup>48</sup> A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired at its original issue directly (or through an underwriter) from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.<sup>350</sup> Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments and the investment must be designated as a qualified equity investment by the CDE. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any

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<sup>44</sup> Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554.

<sup>45</sup> Sec. 45D(a)(2).

<sup>46</sup> Sec. 45D(a)(3).

<sup>47</sup> Sec. 45D(g).

<sup>48</sup> Sec. 45D(c).



loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.<sup>49</sup>

A “low-income community” is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income.<sup>50</sup> For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary is authorized to designate “targeted populations” as low-income communities for purposes of the new markets tax credit.<sup>51</sup> For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994<sup>52</sup> (the “Act”) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of—80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.<sup>53</sup> A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391 of the Code, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of the business is used in a low-income community; (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community; and (4) less than five

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<sup>49</sup> Sec. 45D(d).

<sup>50</sup> Sec. 45D(e).

<sup>51</sup> Sec. 45D(e)(2).

<sup>52</sup> Pub. L. No. 103-325.

<sup>53</sup> Pub. L. No. 103-325.

percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.<sup>54</sup>

The maximum annual amount of qualified equity investments was \$3.5 billion for calendar years 2010 and 2011. The new markets tax credit expired on December 31, 2011.

### **Description of Proposal**

The proposal extends the new markets tax credit for two years, through 2015, permitting up to \$3.5 billion in qualified equity investments for each of the 2014 and 2015 calendar years. The proposal also extends for two years, through 2020, the carryover period for unused new markets tax credits.

### **Effective Date**

The proposal applies to calendar years beginning after December 31, 2013.

## **6. Railroad track maintenance credit (sec. 45G of the Code)**

### **Present Law**

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during taxable years beginning before January 1, 2014.<sup>55</sup> The credit is limited to the product of \$3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.<sup>56</sup> Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit also may reduce a taxpayer's tax liability below its tentative minimum tax.<sup>57</sup> Basis of the railroad track must be reduced (but not below zero) by an amount equal to 100 percent of the taxpayer's qualified railroad track maintenance tax credit determined for the taxable year.<sup>58</sup>

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class

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<sup>54</sup> Sec. 45D(d)(2).

<sup>55</sup> Secs. 45G(a) and (f).

<sup>56</sup> Sec. 45G(b)(1).

<sup>57</sup> Sec. 38(c)(4).

<sup>58</sup> Sec. 45G(e)(3).

II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).<sup>59</sup>

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.<sup>60</sup>

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>61</sup>

### **Description of Proposal**

The proposal extends the present law credit for two years, for qualified railroad track maintenance expenditures paid or incurred in taxable years beginning before January 1, 2016.

### **Effective Date**

The proposal is effective for expenditures paid or incurred in taxable years beginning after December 31, 2013.

## **7. Mine rescue team training credit (sec. 45N of the Code)**

### **Present Law**

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) \$10,000.<sup>62</sup> A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.<sup>63</sup>

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<sup>59</sup> Sec. 45G(d).

<sup>60</sup> Sec. 45G(c).

<sup>61</sup> Sec. 45G(e)(1).

<sup>62</sup> Sec. 45N(a).

<sup>63</sup> Sec. 45N(b).

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States.<sup>64</sup> The term “wages” has the meaning given to such term by section 3306(b)<sup>65</sup> (determined without regard to any dollar limitation contained in that section).<sup>66</sup>

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.<sup>67</sup> The credit does not apply to taxable years beginning after December 31, 2013.<sup>68</sup> Additionally, the credit is not allowable for purposes of computing the alternative minimum tax.<sup>69</sup>

### **Description of Proposal**

The proposal extends the credit for two years through taxable years beginning on or before December 31, 2015.

### **Effective Date**

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

## **8. Employer wage credit for employees who are active duty members of the uniformed services (sec. 45P of the Code)**

### **Present Law**

#### **Differential pay**

In general, compensation paid by an employer to an employee is deductible by the employer unless the expense must be capitalized.<sup>70</sup> In the case of an employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment by the employer is often referred to as “differential pay.”

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<sup>64</sup> Sec. 45N(c).

<sup>65</sup> Section 3306(b) defines wages for purposes of Federal Unemployment Tax.

<sup>66</sup> Sec. 45N(d).

<sup>67</sup> Sec. 280C(e).

<sup>68</sup> Sec. 45N(e).

<sup>69</sup> Sec. 38(c).

<sup>70</sup> Sec. 162(a)(1).

## **Wage credit for differential pay**

If an employer qualifies as an eligible small business employer, the employer is allowed a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the employer's qualified employees during the year.

An eligible small business employer means, with respect to a taxable year, an employer that: (1) employed on average less than 50 employees on business days during the taxable year; and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee. For this purpose, members of controlled groups, groups under common control, and affiliated service groups are treated as a single employer.<sup>71</sup> The credit is not available with respect to an employer that has failed to comply with the employment and reemployment rights of members of the uniformed services.<sup>72</sup>

Differential wage payment means any payment that: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.<sup>73</sup> Eligible differential wage payments are so much of the differential wage payments paid to a qualified employee as does not exceed \$20,000. A qualified employee is an individual who has been an employee of the employer for the 91-day period immediately preceding the period for which any differential wage payment is made.

No deduction may be taken for that portion of compensation that is equal to the credit.<sup>74</sup> In addition, the amount of any other income tax credit otherwise allowable with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to the employee. The credit is not allowable against a taxpayer's alternative minimum tax liability. Certain rules applicable to the work opportunity tax credit in the case of tax-exempt organizations, estates and trusts, and regulated investment companies, real estate investment trusts and certain cooperatives apply also to the differential wage payment credit.<sup>75</sup>

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<sup>71</sup> Sec. 414(b), (c), (m) and (o).

<sup>72</sup> Chapter 43 of Title 38 of the United States Code deals with these rights.

<sup>73</sup> Sec. 3401(h)(2).

<sup>74</sup> Sec. 280C(a).

<sup>75</sup> Sec. 52(c), (d), (e).

The credit is available with respect to amounts paid after June 17, 2008,<sup>76</sup> and before January 1, 2014.

### **Description of Proposal**

The proposal extends the availability of the differential wage payment credit for two years to amounts paid before January 1, 2016.

### **Effective Date**

The proposal applies to payments made after December 31, 2013.

## **9. Work opportunity tax credit (secs. 51 and 52 of the Code)**

### **Present Law**

#### **In general**

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

#### **Targeted groups eligible for the credit**

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

##### **(1) Families receiving TANF**

An eligible recipient is an individual certified by a designated local employment agency (e.g., a State employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program (“TANF”) for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

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<sup>76</sup> The credit was originally provided by the Heroes Earnings Assistance and Relief Tax Act of 2008 (“HEART Act”), Pub. L. No. 110–245, effective for amounts paid after June 17, 2008, the date of enactment of the HEART Act.

## (2) Qualified veteran

Prior to enactment of the “VOW to Hire Heroes Act of 2011” (the “VOW Act”),<sup>77</sup> there were two subcategories of qualified veterans to whom wages paid by an employer were eligible for the credit. Employers who hired veterans who were eligible to receive assistance under a supplemental nutritional assistance program were entitled to a maximum credit of 40 percent of \$6,000 of qualified first-year wages paid to such individual.<sup>78</sup> Employers who hired veterans who were entitled to compensation for a service-connected disability were entitled to a maximum wage credit of 40 percent of \$12,000 of qualified first-year wages paid to such individual.<sup>79</sup>

The VOW Act modified the work opportunity credit with respect to qualified veterans, by adding additional subcategories. There are now five subcategories of qualified veterans: (1) in the case of veterans who were eligible to receive assistance under a supplemental nutritional assistance program (for at least a three month period during the year prior to the hiring date) the employer is entitled to a maximum credit of 40 percent of \$6,000 of qualified first-year wages; (2) in the case of a qualified veteran who is entitled to compensation for a service connected disability, who is hired within one year of discharge, the employer is entitled to a maximum credit of 40 percent of \$12,000 of qualified first-year wages; (3) in the case of a qualified veteran who is entitled to compensation for a service connected disability, and who has been unemployed for an aggregate of at least six months during the one year period ending on the hiring date, the employer is entitled to a maximum credit of 40 percent of \$24,000 of qualified first-year wages; (4) in the case of a qualified veteran unemployed for at least four weeks but less than six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of \$6,000 of qualified first-year wages; and (5) in the case of a qualified veteran unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of \$14,000 of qualified first-year wages.

A veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served

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<sup>77</sup> Pub. L. No. 112-56 (Nov. 21, 2011).

<sup>78</sup> For these purposes, a qualified veteran must be certified by the designated local agency as a member of a family receiving assistance under a supplemental nutrition assistance program under the Food and Nutrition Act of 2008 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a supplemental nutrition assistance program under the Food and Nutrition Act of 2008.

<sup>79</sup> The qualified veteran must be certified as entitled to compensation for a service-connected disability and (1) have a hiring date which is not more than one year after having been discharged or released from active duty in the Armed Forces of the United States; or (2) have been unemployed for six months or more (whether or not consecutive) during the one-year period ending on the date of hiring. For these purposes, being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S. Code, which means having a disability rating of 10 percent or higher for service connected injuries.

for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

### (3) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law; and (2) having a hiring date within one year of release from prison or the date of conviction.

### (4) Designated community resident

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community or a rural renewal community. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget) which had a net population loss during the five-year periods 1990-1994 and 1995-1999. Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community or a rural renewal community.

### (5) Vocational rehabilitation referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code; or (c) an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

### (6) Qualified summer youth employee

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15; (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date; (3) who has not been an employee of that employer before; and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community. As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day



period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified supplemental nutrition assistance program benefits recipient

A qualified supplemental nutrition assistance program benefits recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food and nutrition program under the Food and Nutrition Act of 2008 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food and nutrition assistance under section 6(o) of the Food and Nutrition Act of 2008, the six-month requirement is replaced with a requirement that the family has been receiving food and nutrition assistance for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food and nutrition assistance program under the Food and Nutrition Act of 2008.

(8) Qualified SSI recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income (“SSI”) benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

(9) Long-term family assistance recipient

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if the individual is hired within two years after the date that the 18-month total is reached; or (3) a member of a family who is no longer eligible for family assistance because of either Federal or State time limits, if the individual is hired within two years after the Federal or State time limits made the family ineligible for family assistance.

**Qualified wages**

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer’s deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in sec. 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

**Calculation of the credit**

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year

wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

For calculation of the credit with respect to qualified veterans, see the description of “qualified veteran” above.

### **Certification rules**

Generally, an individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

An otherwise qualified unemployed veteran is treated as certified by the designated local agency as having aggregate periods of unemployment (whichever is applicable under the qualified veterans rules described above) if such veteran is certified by such agency as being in receipt of unemployment compensation under a State or Federal law for such applicable periods. The Secretary of the Treasury is authorized to provide alternative methods of certification for unemployed veterans.

### **Minimum employment period**

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

### **Qualified tax-exempt organizations employing qualified veterans**

The credit is not available to qualified tax-exempt organizations other than those employing qualified veterans. The special rules, described below, were enacted in the VOW Act.

If a qualified tax-exempt organization employs a qualified veteran (as described above) a tax credit against the FICA taxes of the organization is allowed on the wages of the qualified veteran which are paid for the veteran's services in furtherance of the activities related to the function or purpose constituting the basis of the organization's exemption under section 501.

The credit available to such tax-exempt employer for qualified wages paid to a qualified veteran equals 26 percent (16.25 percent for employment of 400 hours or less) of qualified first-year wages. The amount of qualified first-year wages eligible for the credit is the same as those for non-tax-exempt employers (*i.e.*, \$6,000, \$12,000, \$14,000 or \$24,000, depending on the category of qualified veteran).

A qualified tax-exempt organization means an employer that is described in section 501(c) and exempt from tax under section 501(a).

The Social Security Trust Funds are held harmless from the effects of this provision by a transfer from the Treasury General Fund.

### **Treatment of possessions**

The VOW Act provided a reimbursement mechanism for the U.S. possessions (American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, and the United States Virgin Islands). The Treasury Secretary is to pay to each mirror code possession (Guam, the Commonwealth of the Northern Mariana Islands, and the United States Virgin Islands) an amount equal to the loss to that possession as a result of the VOW Act changes to the qualified veterans rules. Similarly, the Treasury Secretary is to pay to each non-mirror Code possession (American Samoa and the Commonwealth of Puerto Rico) the amount that the Secretary estimates as being equal to the loss to that possession that would have occurred as a result of the VOW Act changes if a mirror code tax system had been in effect in that possession. The Secretary will make this payment to a non-mirror Code possession only if that possession establishes to the satisfaction of the Secretary that the possession has implemented (or, at the discretion of the Secretary, will implement) an income tax benefit that is substantially equivalent to the qualified veterans credit allowed under the VOW Act modifications.

An employer that is allowed a credit against U.S. tax under the VOW Act with respect to a qualified veteran must reduce the amount of the credit claimed by the amount of any credit (or, in the case of a non-mirror Code possession, another tax benefit) that the employer claims against its possession income tax.

## **Other rules**

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

## **Expiration**

The work opportunity tax credit is not available for individuals who begin work for an employer after December 31, 2013.

## **Description of Proposal**

The proposal extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2015).

## **Effective Date**

The proposal is effective for individuals who begin work for the employer after December 31, 2013.

## **10. Extension of qualified zone academy bonds (sec. 54E of the Code)**

### **Present Law**

#### **Tax-exempt bonds**

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. These can include tax-exempt bonds which finance public schools.<sup>80</sup> An issuer must file with the Internal Revenue Service certain information about the bonds issued in order for that bond issue to be tax-exempt.<sup>81</sup> Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds does not apply to any arbitrage bond.<sup>82</sup> An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are

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<sup>80</sup> Sec. 103.

<sup>81</sup> Sec. 149(e).

<sup>82</sup> Sec. 103(a) and (b)(2).

reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.<sup>83</sup> In general, arbitrage profits may be earned only during specified periods (*e.g.*, defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (*e.g.*, “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

### **Qualified zone academy bonds**

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue “qualified zone academy bonds.”<sup>84</sup> A total of \$400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2008, \$1,400 million in 2009 and 2010, and \$400 million in 2011, 2012 and 2013. Each calendar years bond limitation is allocated to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and alternative minimum tax liability.

Qualified zone academy bonds are a type of qualified tax credit bond and subject to the general rules applicable to qualified tax credit bonds.<sup>85</sup> The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.<sup>86</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the principal on the bond is 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 100 percent of the available project proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical

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<sup>83</sup> Sec. 148.

<sup>84</sup> See secs. 54E and 1397E.

<sup>85</sup> Sec. 54A.

<sup>86</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Under section 6431 of the Code, an issuer of specified tax credit bonds, may elect to receive a payment in lieu of a credit being allowed to the holder of the bond (“direct-pay bonds”). The Code provides that section 6431 is not available for qualified zone academy bond allocations from the 2011 national limitation or any carry forward of the 2011 allocation.<sup>87</sup>

### **Description of Proposal**

The provision extends the qualified zone academy bond program for two additional years. The proposal authorizes issuance of up to \$400 million of qualified zone academy bonds per year for 2014 and 2015. The option to issue direct-pay bonds is not available for the 2014 and 2015 bond limitation.

### **Effective Date**

The proposal generally applies to obligations issued after December 31, 2013.

## **11. Classification of certain race horses as 3-year property (sec. 168 of the Code)**

### **Present Law**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization.<sup>88</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods,<sup>89</sup> placed-in-

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<sup>87</sup> Sec. 6431(f)(3)(A)(iii). A technical correction may be needed to conform the Code to provide that section 6431 is not available for any allocations from national limitation or carryforward for years 2011 and thereafter.

<sup>88</sup> See secs. 263(a) and 167.

<sup>89</sup> The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. 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

service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>90</sup> In particular, the statute assigns a three-year recovery period for any race horse (1) that is placed in service after December 31, 2008 and before January 1, 2014<sup>91</sup> and (2) that is placed in service after December 31, 2013 and that is more than two years old at such time it is placed in service by the purchaser.<sup>92</sup>

### **Description of Proposal**

The proposal extends the present-law three-year recovery period for race horses for two years to apply to any race horse (regardless of age when placed in service) before January 1, 2016.

### **Effective Date**

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

## **12. 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements (sec. 168 of the Code)**

### **Present Law**

#### **In general**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>93</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the

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recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

<sup>90</sup> Sec. 168.

<sup>91</sup> Sec. 168(e)(3)(A)(i)(I), as in effect after amendment by the Food, Conservation and Energy Act of 2008, Pub .L. No. 110-246, sec. 15344(b).

<sup>92</sup> Sec. 168(e)(3)(A)(i)(II). A horse is more than 2 years old after the day that is 24 months after its actual birthdate. Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785.

<sup>93</sup> Sec. 168.

property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

### **Depreciation of leasehold improvements**

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

### **Qualified leasehold improvement property**

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2014. Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met.<sup>94</sup> The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.<sup>95</sup> If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement.<sup>96</sup> An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.<sup>97</sup>

Qualified leasehold improvement property is generally recovered using the straight-line method and a half-year convention.<sup>98</sup> Qualified leasehold improvement property placed in service after December 31, 2013 is subject to the general rules described above.

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<sup>94</sup> Sec. 168(e)(6).

<sup>95</sup> Secs. 168(e)(6) and (k)(3).

<sup>96</sup> Sec. 168(e)(6)(A).

<sup>97</sup> Sec. 168(e)(6)(B).

<sup>98</sup> Secs. 168(b)(3)(G) and 168(d).



### **Qualified restaurant property**

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2014. Qualified restaurant property is any section 1250 property that is a building or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.<sup>99</sup> Qualified restaurant property is recovered using the straight-line method and a half-year convention.<sup>100</sup> Additionally, qualified restaurant property is not eligible for bonus depreciation.<sup>101</sup> Qualified restaurant property placed in service after December 31, 2013 is subject to the general rules described above.

### **Qualified retail improvement property**

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property placed in service before January 1, 2014. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public<sup>102</sup> and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service.<sup>103</sup> Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.<sup>104</sup> In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.<sup>105</sup>

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. Generally, it is intended that businesses defined as a store retailer under the current North American Industry

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<sup>99</sup> Sec. 168(e)(7).

<sup>100</sup> Secs. 168(b)(3)(H) and 168(d).

<sup>101</sup> Sec. 168(e)(7)(B). Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation. Sec. 3.03(3) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664, 2011.

<sup>102</sup> Improvements to portions of a building not open to the general public (*e.g.*, stock room in back of retail space) do not qualify under the provision.

<sup>103</sup> Sec. 168(e)(8).

<sup>104</sup> Sec. 168(e)(8)(C).

<sup>105</sup> Sec. 168(e)(8)(B).

Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail improvement property is recovered using the straight-line method and a half-year convention.<sup>106</sup> Additionally, qualified retail improvement property is not eligible for bonus depreciation.<sup>107</sup> Qualified retail improvement property placed in service after December 31, 2013 is subject to the general rules described above.

### **Description of Proposal**

The proposal extends the present-law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property for two years to apply to property placed in service before January 1, 2016.

### **Effective Date**

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

## **13. Accelerated depreciation for business property on an Indian reservation (sec. 168(j) of the Code)**

### **Present Law**

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) are determined using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years

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<sup>106</sup> Secs. 168(b)(3)(I) and 168(d).

<sup>107</sup> Sec. 168(e)(8)(D). Property that satisfies the definition of both qualified leasehold improvement property and qualified retail improvement property is eligible for bonus depreciation. Sec. 3.03(3) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664, 2011.

20-year property	12 years
Nonresidential real property	22 years <sup>108</sup>

“Qualified Indian reservation property” eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;<sup>109</sup> and (4) is not property placed in service for purposes of conducting gaming activities.<sup>110</sup> Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (*e.g.*, roads, power lines, water systems, railroad spurs, and communications facilities).<sup>111</sup>

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 (25 U.S.C. 1452(d))<sup>112</sup> or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).<sup>113</sup> For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).<sup>114</sup>

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax.<sup>115</sup> The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or before December 31, 2013.<sup>116</sup>

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<sup>108</sup> Section 168(j)(2) does not provide shorter recovery periods for water utility property, residential rental property, or railroad grading and tunnel bores.

<sup>109</sup> For these purposes, related persons is defined in section 465(b)(3)(C).

<sup>110</sup> Sec. 168(j)(4)(A).

<sup>111</sup> Sec. 168(j)(4)(C).

<sup>112</sup> Pub. L. No. 93-262.

<sup>113</sup> Pub. L. No. 95-608.

<sup>114</sup> Sec. 168(j)(6).

<sup>115</sup> Sec. 168(j)(3).

<sup>116</sup> Sec. 168(j)(8).

## Description of Proposal

The proposal extends for two years the present-law accelerated depreciation for qualified Indian reservation property to apply to property placed in service on or before December 31, 2015.

## Effective Date

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

### **14. Bonus depreciation (sec. 168(k) of the Code)**

#### Present Law

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service acquired after December 31, 2007 and placed in service either before September 9, 2010 or after December 31, 2011 and before January 1, 2014 (January 1, 2015 for certain longer-lived and transportation property).<sup>117</sup> An additional first-year depreciation deduction is allowed equal to 100 percent of the adjusted basis of qualified property if it meets the requirements for the additional first-year depreciation and also meets the following requirements.<sup>118</sup> First, the taxpayer must acquire the property after September 8, 2010 and before January 1, 2012 (January 1, 2013 for certain longer-lived and transportation property).<sup>119</sup> Second, the taxpayer must place the property in service after September 8, 2010 and before January 1, 2012 (January 1, 2013 in the case of certain longer-lived and transportation property). Third, the original use of the property must commence with the taxpayer after September 8, 2010.<sup>120</sup>

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes,<sup>121</sup> but is not allowed for purposes of computing earnings and profits.<sup>122</sup> The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.<sup>123</sup> In addition, there are no adjustments to the allowable amount of depreciation for purposes of

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<sup>117</sup> Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263A.

<sup>118</sup> Sec. 168(k)(5).

<sup>119</sup> For a definition of “acquire” for this purpose, see section 3.02(1)(a) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664, 2011.

<sup>120</sup> See sec. 3.02(1) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664, 2011.

<sup>121</sup> Sec. 168(k)(2)(G).

<sup>122</sup> Treas. Reg. sec. 1.168(k)-1(f)(7).

<sup>123</sup> Sec. 168(k)(1)(B).

computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies.<sup>124</sup> The amount of the additional first-year depreciation deduction is not affected by a short taxable year.<sup>125</sup> The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.<sup>126</sup>

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2013, a taxpayer purchased new depreciable property and placed it in service.<sup>127</sup> The property's cost is \$1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is \$500. The remaining \$500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100, also is allowed as a depreciation deduction in 2013.<sup>128</sup> The total depreciation deduction with respect to the property for 2013 is \$600. The remaining \$400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).<sup>129</sup> Second, the original use<sup>130</sup> of the property must commence with the taxpayer after December 31, 2007.<sup>131</sup>

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<sup>124</sup> Treas. Reg. sec. 1.168(k)-1(d).

<sup>125</sup> *Ibid.*

<sup>126</sup> Sec. 168(k)(2)(D)(iii).

<sup>127</sup> Assume that the cost of the property is not eligible for expensing under section 179.

<sup>128</sup> This simplified example ignores the applicable convention (*e.g.*, half-year).

<sup>129</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. Sec. 168(k)(2)(D)(i). The additional first-year depreciation deduction also is not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2). Sec. 168(k)(2)(D)(ii).

<sup>130</sup> The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (*i.e.*, each fractional owner is considered the original user of its proportionate share of the property). Treas. Reg. sec. 1.168(k)-1(b)(3).

<sup>131</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. Sec. 168(k)(2)(E)(ii).

Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2014. An extension of the placed-in-service date of one year (*i.e.*, before January 1, 2015) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.<sup>132</sup>

To qualify, property must be acquired (1) after December 31, 2007, and before January 1, 2014, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2014.<sup>133</sup> With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2014.<sup>134</sup> Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.<sup>135</sup> For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2014 (“progress expenditures”) is eligible for the additional first-year depreciation deduction.<sup>136</sup>

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner.<sup>137</sup> For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the

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<sup>132</sup> Property qualifying for the extended placed-in-service date must have an estimated production period exceeding one year and a cost exceeding \$1 million. Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property. Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed-in-service-date, if at the time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or \$100,000, and which has an estimated production period exceeding four months and a cost exceeding \$200,000.

<sup>133</sup> Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

<sup>134</sup> Sec. 168(k)(2)(E)(i).

<sup>135</sup> Treas. Reg. sec. 1.168(k)-1(b)(4)(iii).

<sup>136</sup> Sec. 168(k)(2)(B)(ii). For purposes of determining the amount of eligible progress expenditures, rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

<sup>137</sup> Sec. 168(k)(2)(E)(iv).

additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction).<sup>138</sup> The \$8,000 increase is not indexed for inflation.

### **Special rule for long-term contracts**

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method. Solely for purposes of determining the percentage of completion under section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of 7 years or less is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted for property placed in service (1) after December 31, 2009 and before January 1, 2011 (January 1, 2012 in the case of certain longer-lived and transportation property) or (2) after December 31, 2012 and before January 1, 2014 (January 1, 2015 in the case of certain longer-lived and transportation property).<sup>139</sup> Bonus depreciation generally is taken into account in determining taxable income under the percentage-of-completion method for property placed in service after December 31, 2010 and before January 1, 2013.

### **Election to accelerate minimum tax credit in lieu of claiming bonus depreciation**

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional minimum tax credits in lieu of claiming depreciation under section 168(k) for “eligible qualified property” placed in service after December 31, 2010 and before January 1, 2014 (January 1, 2015 in the case of certain longer-lived and transportation property).<sup>140</sup> A corporation making the election increases the limitation under section 53(c) on the use of minimum tax credits in lieu of taking bonus depreciation deductions.<sup>141</sup> The increases in the allowable credits under this provision are treated as refundable.<sup>142</sup> The depreciation for eligible qualified property is calculated for both regular tax and alternative minimum tax purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.<sup>143</sup>

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<sup>138</sup> Sec. 168(k)(2)(F).

<sup>139</sup> Sec. 460(c)(6).

<sup>140</sup> Sec. 168(k)(4). Eligible qualified property means qualified property eligible for bonus depreciation with minor effective date differences.

<sup>141</sup> Sec. 168(k)(4)(B)(ii).

<sup>142</sup> Sec. 168(k)(4)(F).

<sup>143</sup> Sec. 168(k)(4)(A).

The minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation<sup>144</sup> for certain eligible qualified property that could be claimed as a deduction absent an election under this provision.

The bonus depreciation amount is limited to the lesser of (1) \$30 million or (2) six-percent of the minimum tax credits allocable to the adjusted minimum tax imposed for, taxable years beginning before January 1, 2006.<sup>145</sup> All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.<sup>146</sup>

In the case of a corporation making an election which is a partner in a partnership, for purposes of determining the electing partner's distributive share of partnership items, section 168(k)(1) does not apply to any eligible qualified property and the straight-line method is used with respect to such property.<sup>147</sup>

Generally an election under this provision for a taxable year applies to subsequent taxable years.<sup>148</sup>

### **Description of Proposal**

The proposal extends the 50-percent additional first-year depreciation deduction for two years, generally through 2015 (through 2016 for certain longer-lived and transportation property).

The proposal provides that solely for purposes of determining the percentage of completion under section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of 7 years or less which is placed in service after December 31, 2012 and before January 1, 2016 (January 1, 2017, in the case of certain longer-lived and transportation property) is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted.

The proposal also extends the election to increase the AMT credit limitation in lieu of bonus depreciation for two years to property placed in service before January 1, 2016 (January 1, 2017, in the case of certain longer-lived property and transportation property). A bonus

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<sup>144</sup> For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and the shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property. Sec. 168(k)(4)(C).

<sup>145</sup> Sec. 168(k)(4)(C)(iii).

<sup>146</sup> Sec. 168(k)(4)(C)(iv).

<sup>147</sup> Sec. 168(k)(4)(G)(ii).

<sup>148</sup> Special election rules apply as the result of prior extensions of this provision. See secs. 168(k)(4)(H), (I) and (J).



depreciation amount, maximum amount, and maximum increase amount is computed separately with respect to property to which the extension of additional first-year depreciation applies (“round 4 extension property”).<sup>149</sup>

Under the proposal, a corporation that has an election in effect with respect to round 3 extension property to claim minimum tax credits in lieu of bonus depreciation is treated as having an election in effect for round 4 extension property, unless the corporation elects otherwise. The proposal also allows a corporation that does not have an election in effect with respect to round 3 extension property to elect to claim minimum tax credits in lieu of bonus depreciation for round 4 extension property. A separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to round 4 extension property.<sup>150</sup>

The proposal also includes a technical correction with respect to the taxable year for which an election under section 168(k)(4) is made.

### **Effective Date**

Except as noted below, the proposal is effective for property placed in service after December 31, 2013, in taxable years ending after such date.

The proposed technical correction to section 168(k)(4) is effective as if originally included in section 331 of the American Taxpayer Relief Act of 2012 (Pub. L. No. 112-240).

## **15. Enhanced charitable deduction for contributions of food inventory (sec. 170 of the Code)**

### **Present Law**

#### **Charitable contributions in general**

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.<sup>151</sup>

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer’s trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain

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<sup>149</sup> An election with respect to round 4 extension property is binding for all property that is eligible qualified property solely by reason of the extension of the 50-percent additional first-year depreciation deduction.

<sup>150</sup> In computing the maximum amount, the maximum increase amount for round 4 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to round 4 extension property.

<sup>151</sup> Sec. 170.

that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

### **General rules regarding contributions of inventory**

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.*, basis plus one-half of fair market value in excess of basis) or (2) two times basis.<sup>152</sup> In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.<sup>153</sup> To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer and must be contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.<sup>154</sup> In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.<sup>155</sup>

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.<sup>156</sup>

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.<sup>157</sup>

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<sup>152</sup> Sec. 170(e)(3).

<sup>153</sup> Sec. 170(b)(2).

<sup>154</sup> Sec. 170(e)(3)(A)(i)-(iii).

<sup>155</sup> Sec. 170(e)(3)(A)(iv).

<sup>156</sup> Treas. Reg. sec. 1.170A-4A(c)(3).

<sup>157</sup> *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

## **Temporary rule expanding and modifying the enhanced deduction for contributions of food inventory**

Under a temporary provision, any taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for donations of food inventory.<sup>158</sup> For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporations) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.<sup>159</sup>

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." Apparently wholesome food is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The provision does not apply to contributions made after December 31, 2013.

### **Description of Proposal**

The proposal extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2016.

### **Effective Date**

The proposal is effective for contributions made after December 31, 2013.

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<sup>158</sup> Sec. 170(e)(3)(C).

<sup>159</sup> The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

## 16. Increased expensing limitations and treatment of certain real property as section 179 property (sec. 179 of the Code)

### 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.<sup>160</sup> For taxable years beginning in 2013, the maximum amount a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.<sup>161</sup> 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.<sup>162</sup> 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. For taxable years beginning before 2014, 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).<sup>163</sup> 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.<sup>164</sup>

For taxable years beginning in 2014 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 or qualified real property) that is purchased for use in the active conduct of a trade or business.

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).<sup>165</sup> Any amount that is not allowed as a deduction because of

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<sup>160</sup> Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an enterprise zone (sec. 1397A), a renewal community (sec. 1400J), the New York Liberty Zone (sec. 1400L(f)), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

<sup>161</sup> 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 2010, 2011, and 2012, the relevant dollar limitation is \$500,000. Sec. 179(b)(1).

<sup>162</sup> 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 2010, 2011, and 2012, the relevant dollar limitation is \$2,000,000. Sec. 179(b)(2).

<sup>163</sup> Secs. 179(d)(1)(A)(ii) and (f).

<sup>164</sup> Sec. 179(f)(3).

<sup>165</sup> Sec. 179(b)(3).

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.<sup>166</sup> Thus, if a taxpayer's section 179 deduction for 2012 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 2013. Any such carryover amounts that are not used in 2013 are treated as property placed in service in 2013 for purposes of computing depreciation. That is, the unused carryover amount from 2012 is considered placed in service on the first day of the 2013 taxable year.<sup>167</sup>

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.<sup>168</sup> 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.<sup>169</sup>

An expensing election is made under rules prescribed by the Secretary.<sup>170</sup> 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 2014.<sup>171</sup>

### **Description of Proposal**

The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2014 and 2015, 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

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<sup>166</sup> Section 179(f)(4) details the special rules that apply to disallowed amounts.

<sup>167</sup> For example, assume that during 2012, 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 2012, and has a taxable income limitation of \$150,000. The maximum section 179 deduction the company can claim for 2012 is \$150,000, which is allocated pro rata between the properties, such that the carryover to 2013 is allocated \$100,000 to the qualified leasehold improvements and \$50,000 to the equipment.

Assume further that in 2013, the company had no asset purchases and had no taxable income. The \$100,000 carryover from 2012 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2013 taxable year. The \$50,000 carryover allocated to equipment is carried over to 2013 under section 179(b)(3)(B).

<sup>168</sup> Sec. 179(d)(9).

<sup>169</sup> Sec. 312(k)(3)(B).

<sup>170</sup> Sec. 179(c)(1).

<sup>171</sup> Sec. 179(c)(2).

amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000.

In addition, the proposal extends, for taxable years beginning in 2014 and 2015, the treatment of off-the-shelf computer software as qualifying property. The proposal also extends the treatment of qualified real property as eligible section 179 property for taxable years beginning in 2014 and 2015, including the limitation on carryovers and the maximum amount of \$250,000 for each taxable year. For taxable years beginning in 2014 and 2015, the proposal continues to permit a taxpayer to amend or irrevocably revoke an election for a taxable year under section 179 without the consent of the Commissioner.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2013.

## **17. Election to expense mine safety equipment (sec. 179E of the Code)**

### **Present Law**

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.<sup>172</sup> “Qualified advanced mine safety equipment property” means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service after December 20, 2006, and before January 1, 2014.<sup>173</sup>

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane, and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.<sup>174</sup>

### **Description of Proposal**

The proposal extends for two years (through December 31, 2015) the present-law placed in service date allowing a taxpayer to expense 50 percent of the cost of any qualified advanced mine safety equipment property.

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<sup>172</sup> Sec. 179E(a).

<sup>173</sup> Secs. 179E(c) and (g).

<sup>174</sup> Sec. 179E(d).

### **Effective Date**

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

## **18. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 199 of the Code)**

### **Present Law**

#### **General**

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on 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 those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those 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<sup>175</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film<sup>176</sup> produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the

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<sup>175</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

<sup>176</sup> Qualified film includes any motion picture film or videotape (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 the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

calendar year that ends in such taxable year.<sup>177</sup> Wages paid to bona fide residents of Puerto Rico generally are not included in the definition of wages for purposes of computing the wage limitation amount.<sup>178</sup>

### **Rules for Puerto Rico**

When used in the Code in a geographical sense, the term “United States” generally includes only the States and the District of Columbia.<sup>179</sup> A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term “United States” includes the Commonwealth of Puerto Rico, but only if all of the taxpayer’s Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations.<sup>180</sup> In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.<sup>181</sup>

The special rules for Puerto Rico apply only with respect to the first eight taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2014.

### **Description of Proposal**

The proposal extends the special domestic production activities rules for Puerto Rico to apply for the first ten taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2016.

### **Effective Date**

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

## **19. Modification of tax treatment of certain payments to controlling exempt organizations (sec. 512 of the Code)**

### **Present Law**

In general, organizations exempt from Federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the

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<sup>177</sup> For purposes of the provision, “wages” include the sum of the amounts of wages as defined in section 3401(a) 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.

<sup>178</sup> Section 3401(a)(8)(C) excludes wages paid to United States citizens who are bona fide residents of Puerto Rico from the term wages for purposes of income tax withholding.

<sup>179</sup> Sec. 7701(a)(9).

<sup>180</sup> Sec. 199(d)(8)(A).

<sup>181</sup> Sec. 199(d)(8)(B).



organization that is not substantially related to the performance of the organization's tax-exempt functions.<sup>182</sup> In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.<sup>183</sup>

Section 512(b)(13) provides rules regarding income derived by an exempt organization from a controlled subsidiary. In general, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business taxable income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

For payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (*i.e.*, at arm's length).<sup>184</sup> A 20-percent penalty is imposed on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements. This special rule does not apply to payments received or accrued after December 31, 2013.

### **Description of Proposal**

The proposal extends the special rule for two years to payments received or accrued before January 1, 2016. Accordingly, under the provision, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of section 482 (*i.e.*, at arm's length). Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any

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<sup>182</sup> Sec. 511.

<sup>183</sup> Sec. 512(b).

<sup>184</sup> Sec. 512(b)(13)(E).

amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

### **Effective Date**

The proposal is effective for payments received or accrued after December 31, 2013.

## **20. Treatment of certain dividends of regulated investment companies (sec. 871(k) of the Code)**

### **Present Law**

#### **In general**

A regulated investment company (“RIC”) is an entity that meets certain requirements (including a requirement that its income generally be derived from passive investments such as dividends and interest and a requirement that it distribute at least 90 percent of its income) and that elects to be taxed under a special tax regime. Unlike an ordinary corporation, an entity that is taxed as a RIC can deduct amounts paid to its shareholders as dividends. In this manner, tax on RIC income is generally not paid by the RIC but rather by its shareholders. Income of a RIC distributed to shareholders as dividends is generally treated as an ordinary income dividend by those shareholders, unless other special rules apply. Dividends received by foreign persons from a RIC are generally subject to gross-basis tax under sections 871(a) or 881, and the RIC payor of such dividends is obligated to withhold such tax under sections 1441 and 1442.

Under a temporary provision of prior law, a RIC that earned certain interest income that generally would not be subject to U.S. tax if earned by a foreign person directly could, to the extent of such net interest income, designate a dividend it paid as derived from such interest income for purposes of the treatment of a foreign RIC shareholder. A foreign person who is a shareholder in the RIC generally could treat such a dividend as exempt from gross-basis U.S. tax. Also, subject to certain requirements, the RIC was exempt from withholding the gross-basis tax on such dividends. Similar rules applied with respect to the designation of certain short-term capital gain dividends. However, these provisions relating to dividends with respect to interest income and short-term capital gain of the RIC have expired, and therefore do not apply to dividends with respect to any taxable year of a RIC beginning after December 31, 2013.<sup>185</sup>

### **Description of Proposal**

The proposal extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and short-term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2016.

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<sup>185</sup> Secs. 871(k), 881(e), 1441(c)(12), and 1441(a).

### **Effective Date**

The proposal applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2013.

## **21. RIC qualified investment entity treatment under FIRPTA (secs. 897 and 1445 of the Code)**

### **Present Law**

Special U.S. tax rules apply to capital gains of foreign persons that are attributable to dispositions of interests in U.S. real property. In general, although a foreign person (a foreign corporation or a nonresident alien individual) is not generally taxed on U.S. source capital gains unless certain personal presence or active business requirements are met, a foreign person who sells a U.S. real property interest (“USRPI”) is subject to tax at the same rates as a U.S. person, under the Foreign Investment in Real Property Tax Act (“FIRPTA”) provisions codified in section 897 of the Code. Withholding tax is also imposed under section 1445.

A USRPI includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation (as defined) during the testing period. A USRPI does not include an interest in a domestically controlled “qualified investment entity.” A distribution from a “qualified investment entity” that is attributable to the sale of a USRPI is also subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United States and the recipient foreign corporation or nonresident alien individual did not hold more than five percent of that class of stock or beneficial interest within the one-year period ending on the date of distribution.<sup>186</sup> Special rules apply to situations involving tiers of qualified investment entities.

The term “qualified investment entity” includes a real estate investment trust (“REIT”) and also includes a regulated investment company (“RIC”) that meets certain requirements, although the inclusion of a RIC in that definition does not apply for certain purposes after December 31, 2013.<sup>187</sup>

### **Description of Proposal**

The proposal extends the inclusion of a RIC within the definition of a “qualified investment entity” under section 897 through December 31, 2015, for those situations in which that inclusion would otherwise have expired after December 31, 2013.

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<sup>186</sup> Sections 857(b)(3)(F), 852(b)(3)(E), and 871(k)(2)(E) require dividend treatment, rather than capital gain treatment, for certain distributions to which FIRPTA does not apply by reason of this exception. See also section 881(e)(2).

<sup>187</sup> Section 897(h).

## Effective Date

The proposal is generally effective on January 1, 2014.

The proposal does not apply with respect to the withholding requirement under section 1445 for any payment made before the date of enactment, but a RIC that withheld and remitted tax under section 1445 on distributions made after December 31, 2013 and before the date of enactment is not liable to the distributee with respect to such withheld and remitted amounts.

## **22. Exceptions for active financing income (secs. 953 and 954 of the Code)**

### Present Law

Under the subpart F rules,<sup>188</sup> 10-percent-or-greater U.S. shareholders of a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (*i.e.*, income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits (“REMICs”); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC’s country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC’s country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC’s country of organization is taxable as subpart F insurance income.<sup>189</sup>

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<sup>188</sup> Secs. 951-964.

<sup>189</sup> Prop. Treas. Reg. sec. 1.953-1(a).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called “active financing income”).

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country’s tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer’s trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC’s country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any

other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

### **Description of Proposal**

The provision extends for two years (for taxable years beginning before January 1, 2016) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2013, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

## **23. Exclusion of 100 percent of gain on certain small business stock (sec. 1202 of the Code)**

### **Present Law**

#### **In general**

A taxpayer other than a corporation may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.<sup>190</sup> The amount of gain eligible for the exclusion by an individual with respect to the stock of any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million (reduced by the amount of gain eligible for exclusion in prior years). To qualify as a small business, when the stock is issued, the aggregate gross assets (*i.e.*, cash plus aggregate adjusted basis of other property) held by the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>191</sup> Seven percent of the excluded gain is an alternative minimum tax preference.<sup>192</sup>

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<sup>190</sup> Sec. 1202.

<sup>191</sup> Sec. 1(h).

<sup>192</sup> Sec. 57(a)(7).

### **Special rules for stock acquired after February 17, 2009, and before January 1, 2014**

For stock acquired after February 17, 2009, and before September 28, 2010, the percentage exclusion for qualified small business stock sold by an individual is increased to 75 percent.

For stock acquired after September 27, 2010, and before January 1, 2014, the percentage exclusion for qualified small business stock sold by an individual is increased to 100 percent and the minimum tax preference does not apply.

#### **Description of Proposal**

The proposal extends the 100-percent exclusion and the exception from minimum tax preference treatment for two years (for stock acquired before January 1, 2016).

#### **Effective Date**

The proposal is effective for stock acquired after December 31, 2013.

### **24. Basis adjustment to stock of S corporations making charitable contributions of property (sec. 1367 of the Code)**

#### **Present Law**

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.<sup>193</sup> A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.<sup>194</sup>

In the case of charitable contributions made in taxable years beginning before January 1, 2014, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2013, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

#### **Description of Proposal**

The proposal extends the rule relating to the basis reduction on account of charitable contributions of property for two years to contributions made in taxable years beginning before January 1, 2016.

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<sup>193</sup> Sec. 1366(a)(1)(A).

<sup>194</sup> Sec. 1367(a)(2)(B).

## Effective Date

The proposal applies to charitable contributions made in taxable years beginning after December 31, 2013.

## **25. Reduction in S corporation recognition period for built-in gains tax (sec. 1374 of the Code)**

### Present Law

#### In general

A “small business corporation” (as defined in section 1361(b)) may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.<sup>195</sup>

Under section 1374, a corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation’s net recognized built-in gain<sup>196</sup> that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, *i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect.<sup>197</sup> If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no tax under section 1374 is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.<sup>198</sup> Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.<sup>199</sup>

The built-in gains tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation’s basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or

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<sup>195</sup> Sec. 1366.

<sup>196</sup> Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

<sup>197</sup> Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d). A regulated investment company (RIC) or a real estate investment trust (REIT) that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects “deemed sale” treatment. Treas. Reg. secs. 1.1337(d)-7(b)(1) and (c)(1).

<sup>198</sup> Sec. 1374(d)(2).

<sup>199</sup> Treas. Reg. sec. 1.1374-4(h).



other property) in the hands of the C corporation.<sup>200</sup> In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.<sup>201</sup>

The amount of the built-in gains tax under section 1374 is treated as a loss by each of the S corporation shareholders in computing its own income tax.<sup>202</sup>

### **Special rules for 2009, 2010, and 2011**

For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.<sup>203</sup> Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the fifth year in the corporation's recognition period preceded such taxable year.<sup>204</sup> Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the S corporation election was in effect for five years preceding the taxable year beginning in 2011.

### **Special rules for 2012 and 2013**

For taxable years beginning in 2012 and 2013, the term "recognition period" in section 1374, for purposes of determining the net recognized built-in gain, is applied by substituting a five-year period<sup>205</sup> for the otherwise applicable 10-year period. Thus, for such taxable years, the recognition period is the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation apply). If an S corporation with assets subject to section 1374 disposes of such assets in a taxable year beginning in 2012 or 2013 and the disposition occurs more than five years after the first day of the relevant recognition

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<sup>200</sup> Sec. 1374(d)(8).

<sup>201</sup> Sec. 1374(d)(8)(B).

<sup>202</sup> Sec. 1366(f)(2). Shareholders continue to take into account all items of gain and loss under section 1366.

<sup>203</sup> Sec. 1374(d)(7)(B).

<sup>204</sup> Sec. 1374(d)(7)(C).

<sup>205</sup> The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

period, gain or loss on the disposition will not be taken into account in determining the net recognized built-in gain.

The rule requiring the excess of net recognized built-in gain over taxable income for a taxable year to be carried over and treated as recognized built-in gain in the succeeding taxable year applies only to gain recognized within the recognition period. Thus, for example, built-in gain recognized in a taxable year beginning in 2013, from a disposition in that year that occurs beyond the end of the temporary 5-year recognition period, will not be carried forward under the income limitation rule and treated as recognized built-in gain in the taxable year beginning in 2014 (after the temporary provision has expired and the recognition period is again 10 years).

If an S corporation subject to section 1374 sells a built-in gain asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received will be governed by the provisions of section 1374(d)(7) applicable to the taxable year in which the sale was made. Thus, for example, if an S corporation sold a built-in gain asset in 2008 in a sale occurring on or before the recognition period in effect at that time, and reported the gain using the installment method under section 453, gain recognized under that method in 2012 or 2013 (including, for example, any gain under section 453B from a disposition of the installment obligation in those years)<sup>206</sup> is subject to tax under section 1374. On the other hand, if a corporation sold an asset in a taxable year beginning in 2012 or 2013, and the sale occurred beyond the end of the then-effective 5-year recognition period (but not beyond the end of the otherwise applicable 10-year recognition period), then gain reported using the installment method under section 453 in a taxable year beginning in 2014 (after the temporary provision expires) is not subject to tax under section 1374, because the sale was made after the end of the recognition period applicable to that sale. As a third example, if an S corporation sold an asset in a taxable year beginning in 2011, and no tax would have been imposed on the net recognized built-in gain from the sale under section 1374(d)(7)(B)(ii) because the fifth taxable year in the recognition period preceded such taxable year, then gain from such sale reported using the installment method under section 453 in a taxable year beginning in 2014 is not subject to tax under section 1374.

### **Description of Proposal**

The proposal extends, for taxable years beginning in 2014 and 2015, the special rules that applied to taxable years beginning in 2012 and 2013.

### **Effective Date**

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

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<sup>206</sup> Section 453B requires gain or loss to be recognized on disposition of an installment obligation and treated as gain or loss resulting from the sale or exchange of the property in respect of which the installment obligation was received.

## **26. Extension of temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands (sec. 7652(f) of the Code)**

### **Present Law**

A \$13.50 per proof gallon<sup>207</sup> excise tax is imposed on distilled spirits produced in or imported into the United States.<sup>208</sup> The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).<sup>209</sup>

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.<sup>210</sup> The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon before January 1, 2014).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.<sup>211</sup> Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.<sup>212</sup> All of the amounts covered over are subject to the limitation.

### **Description of Proposal**

The proposal suspends for two years the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over limitation of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2013 and before January 1, 2016. After December 31, 2015, the cover over amount reverts to \$10.50 per proof gallon.

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<sup>207</sup> A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

<sup>208</sup> Sec. 5001(a)(1).

<sup>209</sup> Secs. 5214(a)(1)(A), 5002(a)(15), 7653(b) and (c).

<sup>210</sup> Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

<sup>211</sup> Sec. 7652(e)(2).

<sup>212</sup> Secs. 7652(a)(3), (b)(3), and (e)(1).

## Effective Date

The proposal is effective for articles brought into the United States after December 31, 2013.

### **27. Extension of American Samoa Economic Development Credit (sec. 119 of Pub. L. No. 109-432)**

#### Present Law

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006 is allowed a credit based on the corporation's economic activity-based limitation with respect to American Samoa. The credit is not part of the Code but is computed based on the rules of sections 30A and 936. The credit is allowed for the first eight taxable years of a corporation that begin after December 31, 2005, and before January 1, 2014.

A corporation was an existing credit claimant with respect to a American Samoa if (1) the corporation was engaged in the active conduct of a trade or business within American Samoa on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit<sup>213</sup> in an election in effect for its taxable year that included October 13, 1995.<sup>214</sup> A corporation that added

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<sup>213</sup> For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit. Secs. 27(b), 936. This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions. Subject to certain limitations, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment. No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under section 936.

Under the economic activity-based limit, the amount of the credit could not exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes. A taxpayer could elect, instead of the economic activity-based limit, a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income, beginning in 1998, the applicable percentage was 40 percent.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business. Sec. 936(a)(2). The section 936 credit generally expired for taxable years beginning after December 31, 2005.

<sup>214</sup> A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and

a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under section 936 does not apply with respect to the credit allowed by the provision.

For taxable years beginning after December 31, 2011 the credit rules are modified in two ways. First, domestic corporations with operations in American Samoa are allowed the credit even if those corporations are not existing credit claimants. Second, the credit is available to a domestic corporation (either an existing credit claimant or a new credit claimant) only if, in addition to satisfying all the present law requirements for claiming the credit, the corporation also has qualified production activities income (as defined in section 199(c) by substituting "American Samoa" for "the United States" in each place that latter term appears).

In the case of a corporation that is an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006, the credit applies to the first eight taxable years of the corporation which begin after December 31, 2005, and before January 1, 2014. For any other corporation, the credit applies to the first two taxable years of that corporation which begin after December 31, 2011 and before January 1, 2014.

### **Description of Proposal**

The proposal extends the credit to apply (a) in the case of a corporation that is an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006, to the first ten taxable years of the corporation which begin after December 31, 2005, and before January 1, 2016 and (b) in the case of any other corporation, to the first four taxable years of the corporation which begin after December 31, 2011 and before January 1, 2016.

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(2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

**Effective Date**

The proposal applies to taxable years beginning after December 31, 2013.

## **C. Energy Extenders**

### **1. Alternative fuel vehicle refueling property (sec. 30C of the Code)**

#### **Present Law**

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.<sup>215</sup> The credit may not exceed \$30,000 per taxable year per location, in the case of qualified refueling property used in a trade or business and \$1,000 per taxable year per location, in the case of qualified refueling property installed on property which is used as a principal residence.

Qualified refueling property is property (not including a building or its structural components) for the storage or dispensing of a clean-burning fuel or electricity into the fuel tank or battery of a motor vehicle propelled by such fuel or electricity, but only if the storage or dispensing of the fuel or electricity is at the point of delivery into the fuel tank or battery of the motor vehicle. The original use of such property must begin with the taxpayer.

Clean-burning fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen. In addition, any mixture of biodiesel and diesel fuel, determined without regard to any use of kerosene and containing at least 20 percent biodiesel, qualifies as a clean fuel.

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for one year and forward for 20 years. Credits for residential qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

A taxpayer's basis in qualified refueling property is reduced by the amount of the credit. In addition, no credit is available for property used outside the United States or for which an election to expense has been made under section 179.

The credit is available for property placed in service after December 31, 2005, and (except in the case of hydrogen refueling property) before January 1, 2014. In the case of hydrogen refueling property, the property must be placed in service before January 1, 2015.

#### **Description of Proposal**

The proposal extends the 30-percent credit for alternative fuel refueling property for two years (one year in the case of hydrogen refueling property, the credit which continues under present law through 2014), through December 31, 2015.

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<sup>215</sup> Sec. 30C.

### **Effective Date**

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

## **2. Credit for electric motorcycles and three-wheeled vehicles (sec. 30D of the Code)**

### **Present Law**

A 10-percent credit is available for qualifying plug-in electric motorcycles and three-wheeled vehicles.<sup>216</sup> Qualifying two- or three-wheeled vehicles must have a battery capacity of at least 2.5 kilowatt-hours, be manufactured primarily for use on public streets, roads, and highways, and be capable of achieving speeds of at least 45 miles per hours. The maximum credit for any qualifying vehicle is \$2,500. The credit is part of the general business credit. The credit is available for vehicles acquired before January 1, 2014.

### **Description of Proposal**

The proposal extends the credit for electric motorcycles for two years, through December 31, 2015. The credit for electric three-wheeled vehicles is not extended.

### **Effective Date**

The proposal is effective for vehicles acquired after December 31, 2013.

## **3. Extension of second generation biofuel producer credit (sec. 40(b)(6) of the Code)**

### **Present Law**

The second generation biofuel producer credit is a nonrefundable income tax credit for each gallon of qualified second generation biofuel fuel production of the producer for the taxable year. The amount of the credit per gallon is \$1.01. The provision does not apply to fuel sold or used after December 31, 2013.

“Qualified second generation biofuel production” is any second generation biofuel which is produced by the taxpayer and which, during the taxable year, is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified second generation biofuel mixture in such person’s trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such second generation biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).<sup>217</sup> Special rules apply for fuel derived from algae.

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<sup>216</sup> Sec. 30D(g).

<sup>217</sup> In addition, for fuels derived from algae, cyanobacterial or lemna, a special rule provides that qualified second generation biofuel includes fuel that is sold by the taxpayer to another person for refining by such other



“Second generation biofuel” means any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived by or from qualified feedstocks and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (“EPA”) under section 211 of the Clean Air Act. “Qualified feedstock” means any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and any cultivated algae, cyanobacteria or lemna. Second generation biofuel does not include fuels that (1) are more than four percent (determined by weight) water and sediment in any combination, (2) have an ash content of more than one percent (determined by weight), or (3) have an acid number greater than 25 (“unprocessed or excluded fuels”). It also does not include any alcohol with a proof of less than 150.

The second generation biofuel producer credit cannot be claimed unless the taxpayer is registered by the Internal Revenue Service (“IRS”) as a producer of second generation biofuel. Second generation biofuel eligible for the section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.

Because it is a credit under section 40(a), the second generation biofuel producer credit is part of the general business credits in section 38. However, the credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under section 87, the credit is included in gross income.

#### **Description of Proposal**

The proposal extends the credit for two years, through December 31, 2015.

#### **Effective Date**

The proposal is effective for fuel sold or used after December 31, 2013.

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person into a fuel that meets the registration requirements for fuels and fuel additives under section 211 of the Clean Air Act.

#### **4. Incentives for biodiesel and renewable diesel (secs. 40A, 6426 and 6427(e) of the Code)**

##### **Present Law**

##### **Biodiesel**

Present law provides an income tax credit for biodiesel fuels (the “biodiesel fuels credit”).<sup>218</sup> The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includible in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2013.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and (2) the requirements of the American Society of Testing and Materials (“ASTM”) D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, camelina, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

##### **Biodiesel mixture credit**

The biodiesel mixture credit is \$1.00 for each gallon of biodiesel (including agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture.<sup>219</sup> Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

##### **Biodiesel credit (B-100)**

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<sup>218</sup> Sec. 40A.

<sup>219</sup> Notice 2005-62, I.R.B. 2005-35, 443 (2005). “A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture.”

The biodiesel credit is \$1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

#### Small agri-biodiesel producer credit

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel mixture credits. The credit is 10 cents per gallon for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

#### Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.<sup>220</sup> The credit is \$1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.<sup>221</sup>

The credit is not available for any sale or use for any period after December 31, 2013. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

#### Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.<sup>222</sup> The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2013.

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<sup>220</sup> Sec. 6426(c).

<sup>221</sup> Sec. 6426(c)(4).

<sup>222</sup> Sec. 6427(e).

## **Renewable diesel**

“Renewable diesel” is liquid fuel that (1) is derived from biomass (as defined in section 45K(c)(3)), (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM specification for aviation turbine fuel.

For purposes of the Code, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.<sup>223</sup> The incentive for renewable diesel is \$1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2013.

### **Description of Proposal**

The proposal extends the income tax credit, excise tax credit and payment provisions for biodiesel and renewable diesel for two years (through December 31, 2015).

In light of the retroactive nature of the proposal, as it relates to fuel sold or used in 2014, the proposal creates a special rule to address claims regarding excise credits and claims for payment associated with periods occurring during 2014. In particular the proposal directs the Secretary to issue guidance within 30 days of the date of enactment. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2014. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary of the Treasury not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under section 6621 of such Code.

### **Effective Date**

The proposal is effective for sales and uses after December 31, 2013.

## **5. Credit for the production of Indian coal (sec. 45(e)(10) of the Code)**

### **Present Law**

A credit is available for the production of Indian coal sold to an unrelated third party from a qualified facility for a seven-year period beginning January 1, 2006, and ending

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<sup>223</sup> Secs. 40A(f), 6426(c), and 6427(e).

December 31, 2013. The amount of the credit for Indian coal is \$1.50 per ton for the first four years of the seven-year period and \$2.00 per ton for the last three years of the seven-year period. Beginning in calendar years after 2006, the credit amounts are indexed annually for inflation using 2005 as the base year. The credit amount for 2013 is \$2.308 per ton.

A qualified Indian coal facility is a facility placed in service before January 1, 2009, that produces coal from reserves that on June 14, 2005, were owned by a Federally recognized tribe of Indians or were held in trust by the United States for a tribe or its members.

The credit is a component of the general business credit,<sup>224</sup> allowing excess credits to be carried back one year and forward up to 20 years. The credit is also subject to the alternative minimum tax.

### **Description of Proposal**

The proposal extends the credit for the production of Indian coal for two years (through December 31, 2015). The placed-in-service date for qualified facilities is not extended, but the proposal clarifies that qualified Indian coal facilities that are leased or subleased after December 31, 2008, do not lose their eligibility as a result of such lease or sublease.

### **Effective Date**

The proposal is effective for Indian coal produced after December 31, 2013.

## **6. Credit for energy efficient new homes (sec. 45L of the Code)**

### **Present Law**

Present law provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2006 International Energy Conservation Code as in effect (including supplements) on January 1, 2006, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible

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<sup>224</sup> Sec. 38(b)(8).

contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals \$1,000 in the case of a new home that meets the 30-percent standard and \$2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the \$1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2006 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the \$1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2014. The credit is part of the general business credit.

### **Description of Proposal**

The proposal extends the credit to homes that are acquired prior to January 1, 2016.

### **Effective Date**

The proposal is effective for homes acquired after December 31, 2013.

## **7. Special depreciation allowance for second generation biofuel plant property (sec. 168(l) of the Code)**

### **Present Law**

Present law<sup>225</sup> allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified second generation biofuel plant property. In order to qualify, the property generally must be placed in service before January 1, 2014.<sup>226</sup>

Qualified second generation biofuel plant property means depreciable property used in the U.S. solely to produce any liquid fuel that (1) is derived from qualified feedstocks, and (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (“EPA”) under section 211 of the Clean Air Act.<sup>227</sup> Qualified feedstocks means any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis<sup>228</sup> and any cultivated algae, cyanobacteria, or lemna.<sup>229</sup> Second generation biofuel does not

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<sup>225</sup> Sec. 168(l).

<sup>226</sup> Sec. 168(l)(2)(D).

<sup>227</sup> Secs. 168(l)(2)(A) and 40(b)(6)(E).

<sup>228</sup> For example, lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis includes bagasse (from sugar cane), corn stalks, and switchgrass.

include any alcohol with a proof of less than 150 or certain unprocessed fuel.<sup>230</sup> Unprocessed fuels are fuels that (1) are more than four percent (determined by weight) water and sediment in any combination, (2) have an ash content of more than one percent (determined by weight), or (3) have an acid number greater than 25.<sup>231</sup>

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.<sup>232</sup> The additional first-year depreciation deduction is subject to the general rules regarding whether an item is subject to capitalization under section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.<sup>233</sup> In addition, there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies.<sup>234</sup> A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.<sup>235</sup>

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following requirements: (1) the original use of the property must commence with the taxpayer on or after December 20, 2006; and (2) the property must be (i) acquired by purchase (as defined under section 179(d)) by the taxpayer after December 20, 2006, and (ii) placed in service before January 1, 2014.<sup>236</sup> Property does not qualify if a binding written contract for the acquisition of such property was in effect on or before December 20, 2006.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after December 20, 2006, and the property is placed in service before January 1, 2014 (and all other requirements are met).<sup>237</sup> Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

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<sup>229</sup> Sec. 40(b)(6)(F).

<sup>230</sup> Sec. 40(b)(6)(E)(ii) and (iii).

<sup>231</sup> Sec. 40(b)(6)(E)(iii).

<sup>232</sup> Sec. 168(l)(5).

<sup>233</sup> Sec. 168(l)(1)(B).

<sup>234</sup> Secs. 168(l)(5) and 168(k)(2)(G).

<sup>235</sup> Sec. 168(l)(3)(D).

<sup>236</sup> Sec. 168(l)(2).

<sup>237</sup> Sec. 168(l)(4) and 168(k)(2)(E).

Property any portion of which is financed with the proceeds of a tax-exempt obligation under section 103 is not eligible for the additional first-year depreciation deduction.<sup>238</sup> Recapture rules apply if the property ceases to be qualified second generation biofuel plant property.<sup>239</sup>

Property with respect to which the taxpayer has elected 50 percent expensing under section 179C is not eligible for the additional first-year depreciation deduction.<sup>240</sup>

### **Description of Proposal**

The proposal extends the present law special depreciation allowance for two years, to qualified second generation biofuel plant property placed in service prior to January 1, 2016.

### **Effective Date**

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

## **8. Alternative fuel and alternative fuel mixtures (including hydrogen) (sec. 6426 and 6427(e) of the Code)**

### **Present Law**

#### **Fuel excise taxes**

Fuel excise taxes are imposed on taxable fuel (gasoline, diesel fuel or kerosene) under section 4081. In general, these fuels are taxed when removed from a refinery, terminal rack, upon entry into the United States, or upon sale to an unregistered person. A back-up tax under section 4041 is imposed on previously untaxed fuel and alternative fuel used or sold for use as fuel in a motor vehicle or motorboat to the supply tank of a highway vehicle. In general, the rates of tax are 18.3 cents per gallon (or in the case of compressed natural gas 18.3 cents per gasoline gallon equivalent), and in the case of liquefied natural gas, and liquid fuel derived from coal or biomass, 24.3 cents per gallon.

#### **Alternative fuel and alternative fuel mixture credits and payments**

The Code provides two per-gallon excise tax credits with respect to alternative fuel: the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term “alternative fuel” means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process (“coal-to-liquids”),

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<sup>238</sup> Sec. 168(l)(3)(C).

<sup>239</sup> Sec. 168(l)(6).

<sup>240</sup> Sec. 168(l)(7).



compressed or liquefied gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 75 percent of such facility's total carbon dioxide emissions.

The alternative fuel credit is allowed against section 4041 liability, and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents<sup>241</sup> of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An "alternative fuel mixture" is a mixture of alternative fuel and taxable fuel (gasoline, diesel fuel or kerosene) that contains at least 1/10 of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits expired after December 31, 2013 (September 30, 2014 for liquefied hydrogen).

A person may file a claim for payment equal to the amount of the alternative fuel credit (but not the alternative fuel mixture credit). The alternative fuel credit must first be applied to the applicable excise tax liability under section 4041 or 4081, and any excess credit may be taken as a payment. These payment provisions generally also expire after December 31, 2013. With respect to liquefied hydrogen, the payment provisions expire after September 30, 2014.

For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, "alternative fuel" does not include fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

### **Description of Proposal**

The proposal extends the alternative fuel and alternative fuel mixture tax incentives through December 31, 2015 (including those related to hydrogen).

### **Effective Date**

The proposal is generally effective for fuel sold or used after December 31, 2013. As it relates to hydrogen, the proposal is effective for fuels sold or used after September 30, 2014.

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<sup>241</sup> "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

## **TITLE II – PROVISIONS EXPIRING IN 2014**

### **A. Energy Tax Extenders**

#### **1. Credit for new qualified fuel cell motor vehicles (sec. 30B of the Code)**

##### **Present Law**

A credit is available through 2014 for new vehicles propelled by chemically combining oxygen with hydrogen and creating electricity. The base credit is \$4,000 for vehicles weighing 8,500 pounds or less. Heavier vehicles can get up to a \$40,000 credit, depending on their weight. An additional \$1,000 to \$4,000 credit is available to cars and light trucks to the extent their fuel economy exceeds the 2002 base fuel economy set forth in the Code. The credit is available to vehicles purchased before January 1, 2015.

In general, the credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease. In certain cases, where the vehicle is owned by a tax-exempt entity, government, or foreign person, and is not subject to lease, the credit may be claimed by the seller of the vehicle so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

##### **Description of Proposal**

The proposal extends the provision for one year, for vehicles purchased before January 1, 2016.

##### **Effective Date**

The proposal is effective for vehicles purchased after December 31, 2014.

## **B. Extenders Relating to Multiemployer Defined Benefit Pension Plans**

### **1. Multiemployer defined benefit plans (sec. 221(c) of the Pension Protection Act of 2006 and secs. 431-432 of the Code and 304-305 of ERISA)**

#### **Present Law**

##### **Multiemployer plans**

A multiemployer plan is a plan to which more than one unrelated employer contributes, that is established pursuant to one or more collective bargaining agreements, and that meets other requirements as specified by the Secretary of Labor. Multiemployer plans are governed by a board of trustees consisting of an equal number of employer and employee representatives. In general, the level of contributions to a multiemployer plan is specified in the applicable collective bargaining agreements, and the level of plan benefits is established by the plan trustees.

Multiemployer defined benefit plans are subject to minimum funding requirements under the Code and the Employee Retirement Income Security Act of 1974 ("ERISA").<sup>242</sup> Certain changes were made to the funding requirements for multiemployer plans by the Pension Protection Act of 2006 ("PPA").<sup>243</sup> Changes made by PPA are effective for plan years beginning after 2007.

##### **General funding requirements for multiemployer plans**

###### **Minimum required contributions**

In connection with the funding requirements for a multiemployer plan, a notional account called a "funding standard account" is maintained, to which specific charges and credits (including plan contributions) are made for each plan year the multiemployer plan is maintained. The minimum required contribution for a plan year is the amount, if any, needed so that the accumulated credits to the funding standard account as of that plan year are not less than the accumulated charges (*i.e.*, so the funding standard account does not have a negative balance). If, as of the close of a plan year, accumulated charges to the funding standard account exceed credits, the plan has an "accumulated funding deficiency" equal to the amount of the excess.<sup>244</sup> For example, if, as of a plan year, the balance of charges to the funding standard account would be \$200,000 without any contributions, then a minimum contribution equal to that amount is required to meet the minimum funding standard for the year (*i.e.*, to prevent an accumulated funding deficiency). If credits to the funding standard account exceeds charges, a "credit

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<sup>242</sup> Secs. 412 and 431-432 of the Code and secs. 302 and 304-305 of ERISA. Additional rules apply to multiemployer plans that are in reorganization status or insolvent under sections 418-418E of the Code and sections 4241-4245 of ERISA.

<sup>243</sup> Pub. L. No. 109-280.

<sup>244</sup> An excise tax under section 4971 may apply in the case of an accumulated funding deficiency.

balance” results. The amount of the credit balance, increased with interest, reduces future required contributions.

#### Funding method; charges and credits to the funding standard account

In the case of a multiemployer plan, an acceptable actuarial cost method (referred to as a funding method) must be used to determine the elements included in its funding standard account for a year. Generally, a funding method breaks up the cost of benefits under the plan into annual charges to the funding standard account consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan’s normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions (*e.g.*, interest and mortality) had been fulfilled. A plan’s normal cost for a plan year is charged to the funding standard account for that year.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses (*e.g.*, worse than expected investment returns or actuarial experience), losses from changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs are amortized (*i.e.*, recognized for funding purposes) over a specified number of years (generally 15 years) by annual charges to the funding standard account over that period.

Factors that result in a supplemental loss can alternatively result in a gain that is recognized by annual credits to the funding standard account over a 15-year amortization period (in addition to a credit for contributions made each the plan year). These include a reduction in plan liabilities as a result of a plan amendment decreasing plan benefits, net experience gains (*e.g.*, better than expected investment returns or actuarial experience), and gains from changes in actuarial assumptions.

#### Extensions of amortization periods

Before and after PPA, the sponsor of a multiemployer plan (that is, the board of trustees) may obtain from the Secretary of the Treasury (“Secretary”) an extension of up to 10 years of the amortization periods applicable in determining charges to the funding standard account. The extension may be granted by the Secretary if the Secretary determines that (1) the extension would carry out the purposes of ERISA and would provide adequate protection for participants under the plan and (2) the failure to permit the extension would (a) result in a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or

employee compensation and (b) be adverse to the interests of plan participants in the aggregate. The sponsor must also provide satisfactory evidence that notice of the request, including certain information, has been provided to plan participants and beneficiaries, any employee organization representing participants, and the Pension Benefit Guaranty Corporation (“PBGC”).

Under PPA, in addition to an amortization extension described above, the sponsor of a multiemployer plan certified as meeting certain criteria may apply for an amortization extension of up to five years that is required to be approved by the Secretary (referred to as an automatic amortization extension). Included with the application must be a certification by the plan's actuary that (1) absent the extension, the plan would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years, (2) the sponsor has adopted a plan to improve the plan's funding status, (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures, and (4) the required notice described above has been provided. The period of any automatic amortization extension reduces the 10-year period for which an extension described above may be granted by the Secretary. The provision relating to automatic amortization extensions does not apply with respect to any application submitted after December 31, 2014.<sup>245</sup>

#### Shortfall funding method

Certain plans may elect to determine the required charges to the funding standard account under the shortfall funding method. Under this method, the charges are computed on the basis of an estimated number of units of service or production for which a certain amount per unit is to be charged. The difference between the net amount charged under this method and the net amount that otherwise would have been charged for the same period is a shortfall loss or gain that is amortized over subsequent plan years.

In general, the funding method used with respect to a multiemployer plan may be changed only with approval of the Secretary. However, under PPA, certain multiemployer plans may adopt, use or cease using the shortfall funding method and the adoption, use, or cessation of use is deemed approved by the Secretary.<sup>246</sup> Plans are eligible if (1) the plan has not used the shortfall funding method during the five-year period ending on the day before the date the plan is to use the shortfall funding method; and (2) the plan is not operating under an amortization extension and did not operate under such an extension during the five-year period. In general, plan amendments increasing benefit liabilities of the plan cannot be adopted while the shortfall funding method is in use. Deemed approval of a multiemployer plan's adoption, use, or cessation of use of the shortfall funding method does not apply to plan years beginning after December 31, 2014.<sup>247</sup>

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<sup>245</sup> Sec. 431(d)(1)(C) of the Code and sec. 304(d)(1)(C) of ERISA.

<sup>246</sup> Sec. 201(b) of PPA.

<sup>247</sup> Sec. 221(c) of PPA.

## **Additional requirements relating to endangered or critical status**

### In general

Under PPA, additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status.<sup>248</sup> In connection with these rules, not later than the 90th day of each plan year, the actuary for any multiemployer plan must certify to the Secretary and to the sponsor whether or not the plan is in endangered or critical status for the plan year. If a plan is certified to be in endangered or critical status, notice of the endangered or critical status must be provided within 30 days after the date of certification to plan participants and beneficiaries, the bargaining parties, the PBGC and the Secretary of Labor. Additional notice requirements apply in the case of a plan certified to be in critical status.

A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year, (1) the plan's funded percentage for the plan year is less than 80 percent, or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

A multiemployer plan is in critical status for a plan year if as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses),
2. (A) The plan has an accumulated funding deficiency for the current plan year, not taking into account any amortization extension, or (B) the plan is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization extension,
3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value of the reasonably anticipated employer contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of

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<sup>248</sup> Sec. 432 of the Code as enacted by sec. 212 of PPA, and sec. 305 of ERISA, as enacted by sec. 202 of PPA.

active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions), or

4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

#### Requirements during endangered or critical status

Various requirements apply to a plan in endangered or critical status, including adoption of and compliance with (1) a funding improvement plan in the case of a multiemployer plan in endangered status, and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In addition, restrictions on certain plan amendments, benefit increases, and reductions in employer contributions apply during certain periods.

In the case of a multiemployer plan in critical status, additional required contributions (referred to as employer surcharges) apply until the adoption of a collective bargaining that is consistent with the rehabilitation plan. In addition, employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules (and the related excise tax), provided that a rehabilitation plan is adopted and followed.<sup>249</sup> Moreover, subject to notice requirements, some benefits that would otherwise be protected from elimination or reduction may be eliminated or reduced in accordance with the rehabilitation plan.<sup>250</sup>

A funding improvement plan is a plan consisting of actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements within a certain period (generally 10 years), referred to as the funding improvement period. The funding improvement plan must provide that, by the end of the funding improvement period, the plan will have a certain required increase in the funded percentage and no accumulated funding deficiency for any plan year during the funding improvement period.

In general, a rehabilitation plan is a plan consisting of actions, including options or a range of options to be proposed to the bargaining parties, formulated, based on reasonable anticipated experience and reasonable actuarial assumptions, to enable the plan to cease to be in

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<sup>249</sup> Code sec. 4971(g)(1)(A).

<sup>250</sup> The rules for multiemployer plans in critical status include the elimination or reduction of “adjustable benefits,” which include some benefits that would otherwise be protected from elimination or reduction under the anticutback rules under section 411(d)(6) of the Code and section 204(g) of ERISA.

critical status within a certain period (generally 10 years), referred to as the rehabilitation period, and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefits accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions. A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation. The plan must also include the schedules required to be provided to the bargaining parties.

If the sponsor of a plan in critical status determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

The sponsor of the multiemployer plan must update the funding improvement or rehabilitation plan annually.

In the case of a failure to meet the requirements applicable to a multiemployer plan in endangered or critical status, the plan actuary, plan sponsor, or employers required to contribute to the plan may be subject to an excise tax under the Code or a civil penalty under ERISA.<sup>251</sup>

#### Sunset of endangered and critical rules

The rules relating to endangered and critical status generally do not apply to plan years beginning after December 31, 2014.<sup>252</sup> However, if a multiemployer plan is operating under a funding improvement or rehabilitation plan for its last plan year beginning before January 1, 2015, that is, for its 2014 plan year, the multiemployer plan must continue to operate under the funding improvement or rehabilitation plan during any period after December 31, 2014, that the funding improvement or rehabilitation plan is in effect, and all of the Code and ERISA provisions relating to the operation of the funding improvement or rehabilitation plan continue in effect during that period.

#### **Description of Proposal**

Under the proposal, the PPA provisions relating to automatic extensions of amortization periods, deemed approval of a multiemployer plan's adoption, use, or cessation of use of the shortfall funding method, and rules relating to endangered and critical status are extended for one year. Thus, the provision relating to automatic amortization extensions does not apply with respect to any application submitted after December 31, 2015. Deemed approval of a

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<sup>251</sup> Code sec. 4971(g) and ERISA sec. 502(c)(8). In addition, certain failures are treated as a failure to file an annual report with respect to the multiemployer plan, subject to a civil penalty under ERISA.

<sup>252</sup> Sec. 221(c) of PPA.



multiemployer plan's adoption, use, or cessation of use of the shortfall funding method, and the rules relating to endangered and critical status do not apply to plan years beginning after December 31, 2015. However, if a multiemployer plan is operating under a funding improvement or rehabilitation plan for its last plan year beginning before January 1, 2016, that is, for its 2015 plan year, the multiemployer plan must continue to operate under the funding improvement or rehabilitation plan during any period after December 31, 2015, that the funding improvement or rehabilitation plan is in effect, and all of the Code and ERISA provisions relating to the operation of the funding improvement or rehabilitation plan continue in effect during that period.

#### **Effective Date**

The proposal relating to automatic extensions of amortization periods applies to applications submitted to the Secretary after December 31, 2014. The proposal relating to deemed approval of a multiemployer plan's adoption, use, or cessation of use of the shortfall funding method and the rules relating to endangered and critical status applies to plan years beginning after December 31, 2014.