TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE VII – EXCISE TAXES

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 26, 2014
JCX-18-14

CONTENTS

INTRODUCTION

This document[1] provides a technical explanation of Title VII of the Tax Reform Act of 2014, a discussion draft[2] prepared by the Chairman of the House Committee on Ways and Means that proposes to reform the Internal Revenue Code. Title VII of the proposal addresses excise tax reform.

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[1] This document may be cited as follows: Joint Committee on Taxation*, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VII ─ Excise Taxes* (JCX-18-14), February 26, 2014. This document can also be found on our website at www.jct.gov.

[2] Statutory draft version Camp_041.XML.

TITLE VII – EXCISE TAXES

1. Repeal of medical device excise tax (sec. 7001 of the discussion draft and sec. 4221 of the Code)

Present Law

A tax equal to 2.3 percent of the sale price is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of such device.[3] A taxable medical device is any device, as defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act,[4] intended for humans. Regulations further define a medical device as one that is listed by the Food and Drug Administration ("FDA") under section 510(j) of the Federal Food, Drug, and Cosmetic Act and 21 C.F.R. Part 807, pursuant to FDA requirements.[5]

The excise tax does not apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by the Secretary to be of a type that is generally purchased by the general public at retail for individual use ("retail exemption"). Regulations provide guidance on the types of devices that are exempt under the retail exemption. A device is exempt under these provisions if: (1) it is regularly available for purchase and use by individual consumers who are not medical professionals; and (2) the design of the device demonstrates that it is not primarily intended for use in a medical institution or office or by a medical professional.[6] Additionally, the regulations provide certain safe harbors for devices eligible for the retail exemption.[7]

The medical device excise tax is generally subject to the rules applicable to other manufacturers excise taxes. These rules include certain general manufacturers excise tax exemptions including the exemption for sales for use by the purchaser for further manufacture (or for resale to a second purchaser in further manufacture) or for export (or for resale to a

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[3] Sec. 4191.

[4] 21 U.S.C. sec. 321. Section 201(h) defines device as an instrument, apparatus, implement, machine, contrivance, implant, in vitro reagent, or other similar or related article, including any component, part, or accessory, which is (1) recognized in the official National Formulary, or the United States Pharmacopeia, or any supplement to them, (2) intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment, or prevention of disease, in man or other animals, or (3) intended to affect the structure or any function of the body of man or other animals, and which does not achieve its primary intended purposes through chemical action within or on the body of man or other animals and which is not dependent upon being metabolized for the achievement of its primary intended purposes.

[5] Treas. Reg. sec. 48.4191-2(a). The regulations also include as devices items that should have been listed as a device with the FDA as of the date the FDA notifies the manufacturer or importer that corrective action with respect to listing is required.

[6] Treas. Reg. sec. 48.4191-2(b)(2).

[7] Treas. Reg. sec. 48.4191-2(b)(2)(iii). The safe harbor includes devices that are described as over-the-counter devices in relevant FDA classification headings as well as certain other FDA device classifications listed in the regulations.

second purchaser for export).[8] If a medical device is sold free of tax for resale to a second purchaser for further manufacture or for export, the exemption does not apply unless, within the six-month period beginning on the date of sale by the manufacturer, the manufacturer receives proof that the medical device has been exported or resold for use in further manufacturing.[9] In general, the exemption does not apply unless the manufacturer, the first purchaser, and the second purchaser are registered with the Secretary of the Treasury. Foreign purchasers of articles sold or resold for export are exempt from the registration requirement.

The lease of a medical device is generally considered to be a sale of such device.[10] Special rules apply for the imposition of tax to each lease payment. The use of a medical device subject to tax by manufacturers, producers, or importers of such device, is treated as a sale for the purpose of imposition of excise taxes.[11]

There are also rules for determining the price of a medical device on which the excise tax is imposed.[12] These rules provide for (1) the inclusion of containers, packaging, and certain transportation charges in the price, (2) determining a constructive sales price if a medical device is sold for less than the fair market price, and (3) determining the tax due in the case of partial payments or installment sales.

Description of Proposal

The proposal repeals the medical device excise tax.

Effective Date

The proposal applies to sales after the date of enactment.

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[8] Sec. 4221(a). Other general manufacturers excise tax exemptions (*i.e.*, the exemption for sales to vessels or aircraft, to a State or local government, to a nonprofit educational organization, or to a qualified blood collector organization) do not apply to the medical device excise tax.

[9] Sec. 4221(b).

[10] Sec. 4217(a).

[11] Sec. 4218.

[12] Sec. 4216.

2. Modifications relating to the Oil Spill Liability Trust Fund (sec. 7002 of the discussion draft and secs. 4611 and 4612 of the Code)

Present Law

Oil Spill Liability Trust Fund

Amounts in the Oil Spill Liability Trust Fund are available, as provided in appropriation Acts or section 6002(b) of the Oil Pollution Act of 1990, for the following oil spill-related expenditures:

1. Payment of removal costs and other costs, expenses, claims, and damages under section 1012 of the 1990 Act;

2. Costs relating to oil pollution or the substantial threat of oil pollution (under sections 5 and 7 of the Intervention on the High Seas Act);

3. Payment of liabilities incurred by the revolving fund under section 311(k) of the Federal Water Pollution Control Act;

4. Payments for prevention, removal, and enforcement related to oil discharges (under section 311(b)-(d), (j), and (l) of the Federal Water Pollution Control Act);

5. Payment of liabilities incurred by the Deepwater Port Liability Fund; and

6. Payment of liabilities incurred by the Offshore Pollution Compensation Fund.

There is a general limit of $1 billion per incident that may be paid out of the Oil Spill Liability Trust Fund, with costs of natural resource damage assessments and claims for any single incident limited to $500 million. Except in the case of payments of oil removal costs, payments may be made from the Trust Fund only if the Fund maintains a minimum balance of $30 million after such payment. Any claim filed against the Oil Spill Liability Trust Fund may be paid only out of the Fund.

Tax and exemptions

The Oil Spill Liability Trust Fund is largely financed with revenues from an eight-cents-per-barrel[13] excise tax on crude oil received at a United States refinery and on imported petroleum products.[14] The tax rate is scheduled to increase to nine cents per barrel in calendar

[13] A barrel equals 42 gallons.

[14] Sec. 4611(a). Petroleum products include crude oil (sec. 4612(a)(3)). Statutorily, the tax also applies to domestic crude oil exported from the United States before being received at a U.S. refinery (sec. 4611(b)(1)).

year 2017, after which it currently is scheduled to expire.[15] A back-up "use tax" is imposed on crude oil that is used in or exported from the United States before being received at a refinery.[16]

Types of "oil"

Tar sands[17]

"Tar sands" or "oil sands" generally refers to a mixture of sand, clay or other minerals, water and bitumen. Bitumen is a form of crude oil that is very dense, often said to have the consistency of molasses and very viscous (resistant to flow). Because bitumen is resistant to flow, and thus impractical for pipeline transportation, the bitumen is processed or diluted to facilitate transportation. "Upgraded bitumen," also known as "synthetic crude oil" or "SCO" is produced from bitumen to convert the heavy hydrocarbon into lighter material. "Diluted bitumen," or "dilBit", is bitumen that is blended with lighter hydrocarbons (typically natural gas condensates) to create a lighter, easier flowing and transportable material. "Synthetic bitumen," or "Synbit," is typically a combination of synthetic crude oil and bitumen, which improves the flow properties of the bitumen. The vast majority of oil derived from tar sands is transported via pipeline.

Shale oil[18]

Shale oil is petroleum that is trapped in low permeability sedimentary shale. The low permeability prevents the petroleum from freely flowing into a drilled well. The current practice is to hydraulically fracture the shale rock surrounding the well in order to release the petroleum from the rock and allow it to flow into the well hole and be produced.

Oil shale[19]

Oil shale is sedimentary rock containing organic matter known as "kerogen." The kerogen must be heated to release a petroleum-like product.

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15 For Federal budget scorekeeping purposes, the oil spill excise tax is assumed to be permanent.

16 Sec. 4611(b).

17 See, U.S. Bureau of Land Management, 2012 Oil Shale & Tar Sands Programmatic EIS Information Center, Tar Sands Basics (2012) <http://osteis.anl.gov/guide/tarsands/indes.cfm>; United States Geological Survey, Natural Bitumen Resources of the United States (Fact Sheet 2006-3133, November 2006); and Congressional Research Service, Oil Sands and the Keystone XL Pipeline: Background and Selected Environmental Issues (CRS Report R42611, July 16, 2012).

18 See, Congressional Research Service, The Bakken Formation: An Emerging Unconventional Oil Resource (CRS Report R42032, September 28, 2011) at p.1.

19 *Ibid*.

“Crude oil” for purposes of the Oil Spill Trust Fund financing rate

Under the Code, the term “crude oil” is defined to include crude oil condensates and natural gasoline. “Domestic crude oil” means “any crude oil produced from a well located in the United States. Under a special rule, natural gasoline produced from natural gas at a refinery is treated as received at the refinery at the time of its production and is subject to tax at that time.

Relying on a House Ways and Means Committee report, the IRS stated in a technical advice memorandum that tar sands are not subject to tax for purposes of the Code.[20] The committee report provides that the term “crude oil,” for purposes of this tax does not include synthetic petroleum. Thus, the Committee stated, “'crude oil' does not include shale oil, liquids from coal, tar sands, or biomass, or refined oil.”[21]

“Oil” for purposes of the Oil Pollution Act of 1990

Under the Oil Pollution Act of 1990 and for purposes of making expenditures from the Oil Spill Liability Trust Fund, the definition of oil is very broad.[22] “Oil” means oil of any kind in any form, including petroleum, fuel oil, sludge, oil refuse and oil mixed with wastes other than dredged spoil. It does not include any substance that is specifically listed or designated as a hazardous substance under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and subject to the provisions of that Act.

Tar sands and oil from tar sands would fit within this definition of “oil” but under the IRS interpretation, such material is not subject to the tax that funds the Oil Spill Liability Trust Fund. As a result, costs of a spill of oil from tar sands would be covered by the Oil Spill Liability Trust Fund, although oil from tar sands is not subject to the tax. For example, in 2010, there was a pipeline spill into the Kalamazoo River in Michigan involving oil from tar sands.[23]

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[20] See Tech. Adv. Memo 201120019; 2011 WL 1915850 (January 12, 2011) noting that the statutory text was ambiguous and, based on House Committee report language, concludes that tar sands imported into the United States are not subject to the excise tax on petroleum imposed by section 4611 (which provides for the Oil Spill Liability Trust Fund financing rate and the expired Hazardous Substance Superfund financing rate for the tax on crude oil and petroleum products).

[21] H.R. Rep. 96-1016(II), 1980 U.S.C.C.A.N. 6151, 6154 (96th Cong. 2nd Sess. 1980).

[22] 33 U.S.C. sec. 2701(23).

[23] See, Environmental Protection Agency, EPA's Response to the Enbridge Oil Spill in Michigan (October 3, 2012) <http://www.epa.gov/enbridgespill/ar/index html>. (“Enbridge Energy Partners LLP (Enbridge) reported a 30-inch pipeline ruptured on Monday, July 26, 2010, near Marshall, Michigan. The release, estimated at 819,000 gallons, entered Talmadge Creek and flowed into the Kalamazoo River, a Lake Michigan Tributary.” As of October 3, 2012, oil response workers had collected over 1.1 million gallons of oil.). According to information obtained by the Congressional Research Service from the U.S. Coast Guard, as of January 30, 2012, approximately $45 million had been obligated from the Oil Spill Liability Trust Fund with respect to this spill.

Description of Proposal

The proposal extends the Oil Spill Trust Fund financing rate through December 31, 2023. In addition, the proposal provides that crude oil, for purposes of the tax to fund the Oil Spill Liability Trust Fund, includes bitumen and bituminous mixtures (for example, tar sands, and oil derived from tar sands, such as synthetic crude oil from bitumen, and mixtures, such as diluted bitumen, and synthetic bitumen). The proposal also expands crude oil to include oil from kerogen-bearing sources, such as oil shale. It is also intended that shale oil be included within the definition of crude oil for this purpose since it is a form of petroleum. In addition, since tar sands and oil shale may be mined or quarried rather than produced from a well, the proposal modifies the definition of domestic crude oil to eliminate the requirement that the oil be produced from a well.

Effective Date

The proposal is effective for calendar quarters beginning more than 60 days after the date of enactment.

3. Modification relating to Inland Waterways Trust Fund financing rate (sec. 7003 of the discussion draft and sec. 4042 of the Code)

Present Law

Tax and exemptions

A 20-cents-per-gallon excise tax is imposed on fuel used in powering commercial cargo vessels on a designated system of inland or intra-coastal waterways.[24] This tax is permanent. The tax applies to fuel used on any specified inland or intracoastal waterway of the United States in the business of transporting property for compensation or hire, or in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage).[25] The inland waterways excise tax is a use tax, imposed on the boat operator.

Exemptions are provided for vessels designed primarily for use on the high seas which have a draft of more than 12 feet ("deep-draft ocean-going vessels"), for vessels used primarily for transportation of persons, for State or local government vessels engaged in governmental business, and for use in tugboat movement of LASH ("lighter-aboard-ship") and SEABEE ocean-going barges used exclusively to ferry international cargoes to or from their carriers.

[24] Sec. 4042. Like other taxable motor fuels, inland waterway fuels are subject to an additional excise tax of 0.1 cent per gallon to fund the Leaking Underground StorageTrust Fund.

[25] The term inland or intracoastal waterway of the United States means any inland or intracoastal waterway of the United States which is described in section 206 of the Inland Waterways Revenue Act of 1978 and includes the Mississippi River upstream from Baton Rouge, the Mississippi River's tributaries, and specified waterways, including the Gulf of Mexico and Atlantic Intra-coastal Waterways, and the Tennessee-Tombigbee Waterway.

Overview of Inland Waterways Trust Fund expenditure provisions

Amounts in the Inland Waterways Trust Fund are available, as provided by appropriation Acts, for making construction and rehabilitation expenditures for navigation on the inland and coastal waterways of the United States described in section 206 of the Inland Waterways Revenue Act of 1978, as in effect on the date of the enactment of section 9506. There is a limit of 50 percent that can be paid from the Inland Waterways Trust Fund for the cost of any construction under section 102(a) of the Water Resources Development Act of 1986 (as in effect on the date of enactment of section 9506). The remaining 50 percent is to be paid from the General Fund.

Description of Proposal

The proposal increases the inland waterways fuel excise tax from 20 cents to 26 cents per gallon.

Effective date

The proposal is effective for fuel used after December 31, 2014.

4. Excise tax on systemically important financial institutions (sec. 7004 of the discussion draft and new sec. 4491 of the Code)

Present Law

There is no sector-specific Federal excise tax applicable to financial institutions.

Corporations generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[26] generally is composed of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Corporations that make a valid election pursuant to section 1362 of subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead,

[26] Corporations subject to tax are commonly referred to as C corporations after subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (Real Estate Investment Trusts) or in stock and securities (Regulated Investment Companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items upon a subsequent disposition of S corporation stock, each shareholder's basis in such stock is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

To qualify for S corporation status, a corporation must be a small business corporation as defined in section 1361(b)(1) and not be an ineligible corporation as defined in section 1361(b)(2). A corporation qualifies as a small business corporation if it has 100 or fewer shareholders, has only individuals or certain trusts and estates as shareholders, has no nonresident aliens as shareholders, and has only one class of stock. Ineligible corporations include any financial institution using the reserve method of accounting for bad debts (discussed below) and any insurance company subject to subchapter L of the Code.

Banks, thrifts, and credit unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with certain specified exceptions. There is no sector-specific Federal income tax currently applied to financial institutions, and there are currently no corporate taxes assessed on the balance sheet liabilities of an entity.

Certain special rules and exceptions that are applicable to determining the Federal income tax liability of banks and thrifts, certain other financial institutions, insurance companies, and broker dealers are discussed below.

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[27] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[28] Prior to 1951, thrifts were exempt from Federal taxation. In 1951, mutual savings banks and savings and

[27] Sec. 581.

[28] See Treas. Reg. sec. 1.581-1 ("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank…there are certain exceptions and special rules [for such institutions]").

loan associations lost their tax exemption because they were viewed as being "in active competition with commercial banks and life insurance companies for the public savings."[29]

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.[30]

Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. For taxable years beginning before 1987, section 166(c) allowed taxpayers to deduct annual reasonable additions to a reserve established for bad debts (in lieu of deducting specific debts as worthless in the year in which the bank determined the debt was worthless). The reserve method of accounting for bad debts was repealed in 1986[31] for most taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

Prior to 1996, thrifts (mutual savings banks, domestic savings and loan associations, and cooperative banks) had separate bad debt reserve rules under section 593. The special rules for thrifts were repealed for tax years beginning on or after January 1, 1996.[32]

Credit unions

Credit unions are exempt from Federal income taxation.[33] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of

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[29] S. Rep. No. 82-781, Revenue Act of 1951, p. 25.

[30] Sec. 1361(b)(2).

[31] Tax Reform Act of 1986, Pub. L. No. 99-514.

[32] The Small Business and Job Protection Act of 1996, Pub. L. No. 104-188.

[33] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070 htm.

common bond has been expanded to permit greater utilization of credit unions.[34] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[35]

Gains and losses with respect to securities held by financial institutions

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain of a corporation is currently taxed at a rate not to exceed 35 percent, which is also the maximum corporate income tax rate. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges. Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income. However, in general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year.

In the case of an S corporation, net capital losses flow through to the corporation's shareholders and could be considered losses attributable to a banking business in such shareholders' hands. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the assets, liabilities, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year

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[34] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

[35] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070 htm.

attributable to that banking business. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; (5) certain U.S. publications; (6) certain commodity derivative financial instruments; (7) hedging transactions; and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Under section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. Thus, generally, as a manufacturer receives ordinary income treatment on sale of its inventory, so does a financial institution on the sale or exchange of its loans under section 582. A financial institution described in section 582(c)(2) includes: (1) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation); (2) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law; (3) any small business investment company operating under the Small Business Investment Act of 1958; and (4) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Stock (including preferred stock) is not considered indebtedness for tax purposes and therefore is not treated as an asset entitled to ordinary gain or loss treatment under section 582.[36] However, under section 301 of Division A of the Emergency Economic Stabilization Act of 2008, gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company, as defined in the Federal Deposit Insurance Act.[37] Applicable preferred stock

[36] Under section 306 of the Code, the sale of certain preferred stock can produce ordinary income to any taxpayer (without regard to section 582).

[37] 12 U.S.C. sec. 1813(w)(1).

is preferred stock of Fannie Mae or Freddie Mac that was (1) held by the applicable financial institution on September 6, 2008, or (2) sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[38]

Insurance companies

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Generally, an insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[39] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

A life insurance company is subject to tax on its life insurance company taxable income.[40] Life insurance company taxable income is the sum of premiums and other consideration on insurance and annuity contracts, decreases in certain reserves, and other amounts includible in gross income, reduced by allowable deductions for all claims and benefits accrued and all losses incurred during the taxable year, increases in certain reserves, policyholder dividends, dividends received, operations losses, certain reinsurance payments, and other deductions allowable for purposes of computing taxable income.[41]

The taxable income of a property and casualty insurance company is the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[42] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Certain special rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance

[38] On September 7, 2008, the Federal Housing Finance Agency (“FHFA”) placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9 percent of the common stock of such companies.

[39] Sec. 816.

[40] Sec. 801.

[41] Secs. 801-818.

[42] Sec. 832.

agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[43]

Broker-dealers

For Federal income tax purposes, a person generally is a securities dealer if such person regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[44] The determination of dealer status is made based on all facts and circumstances. The courts and the IRS have considered the following factors in evaluating dealer status: (1) being licensed as a dealer;[45] (2) holding oneself out to the public as a dealer;[46] (3) selling inventoried securities to customers;[47] (4) the frequency, extent, and regularity of securities transactions;[48] (5) profiting from commissions as opposed to appreciation in the value of securities;[49] and (6) ownership of a securities exchange membership.[50]

Securities dealers must account for their securities inventory using the mark-to-market accounting method.[51] In general, under that method, securities held by a dealer in its inventory are marked to fair market value at the close of the taxable year, with any resulting difference between value and basis included as ordinary income or loss in computing taxable income for such year. For this purpose a security is defined as any share of stock in a corporation, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, interest rate, currency, or equity notional principal contract, and evidence of an interest in, or a derivative financial instrument in any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.[52] Additionally, a security

[43] Secs. 841-848.

[44] Sec. 475(c)(1) (defining a securities dealer for purposes of section 475); cf. Treas. Reg. sec. 1.864-2(c)(2)(iv) (defining a dealer in stock or securities for purposes of the trader safe harbors to section 864) and Treas. Reg. sec. 1.471-5 (as amended in 1993).

[45] *Polachek v. Commissioner,* 22 T.C. 858, 859 (1954).

[46] *Verito v. Commissioner,* 43 T.C. 429, 441-442 (1965), acq. 1965-2 C.B. 7.

[47] *United States v. Chinook Investment Co.,* 136 F.2d 984 (9th Cir. 1943).

[48] *Purvis v. Commissioner,* 530 F.2d 1332, 1334 (9th Cir. 1976).

[49] *Kemon v. Commissioner*, 16 T.C. 1026, 1033 (1951).

[50] *Securities Allied Corp. v. Commissioner*, 95 F.2d 284, 286 (2d Cir. 1938), aff'g 36 B.T.A 168 (1937), cert denied, 305 U.S. 617 (1938).

[51] Sec. 475.

[52] Sec. 475(c)(2). The definition of securities under section 475 excludes sec. 1256 contracts, which include futures contracts and certain exchange-traded options.

includes a position that is not one of the foregoing, but is a hedge with respect to such security, and is clearly identified in the dealer's records as a security before the close of the day on which it was acquired.[53]

Special rules apply to gains and losses of a securities dealer with respect to "section 1256 contracts."[54] Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.[55] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[56]

A securities dealer may also hold securities for investment rather than as inventory (such securities are not subject to mark-to-market accounting, and any gains or losses with respect thereto treated as capital rather than ordinary).[57] Additionally, a dealer is not subject to mark-to-market accounting for debt securities originated or entered into in the ordinary course of its trade or business that are not held for sale.[58] For either of these exceptions to apply, the dealer must clearly identify that the security is either held for investment or not held for sale by the close of the day the security is acquired and the security may not at any time thereafter be held primarily for sale to customers.[59]

Description of Proposal

The proposal applies a tax of 0.035 percent on the excess total consolidated assets of any systemically important financial institution at the close of each calendar quarter. The tax is due on the first day of the third month beginning after the close of each calendar quarter.

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[53] Sec. 475(c)(2)(F).

[54] Section 1256(b) provides that a "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract; (3) nonequity option, (4) dealer equity option; and (5) dealer securities futures contract, but does not include any securities future contract or option on such contract unless such contract or option is a dealer securities future contract, or any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap , or similar agreement.

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

[56] Sec. 1256(c)(1). Additionally, section 1212(c) provides that a taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.

[57] Secs. 1236 and 475(b)(1).

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

[59] Secs. 1236(a) and (d)(1). See also section 475(b)(2).

A systemically important financial institution is any person subject to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[60] Generally, an institution is subject to the section 165 of Dodd-Frank if it is a nonbank financial company supervised by the Board of Governors of the Federal Reserve ("Federal Reserve Board") or a bank holding company with total consolidated assets equal to or greater than $50 billion.

Excess total consolidated assets are total consolidated assets in excess of $500 billion. The term total consolidated assets has the same meaning as for section 165 of Dodd-Frank. Generally, total consolidated assets are reported on regulatory filings required by the Federal Reserve Board.[61]

In the case of any calendar year beginning after 2015, the $500 billion threshold is indexed to the change in gross domestic product ("GDP"). GDP for any calendar year means the latest estimate of GDP as published by the Department of Commerce for the preceding calendar year. Thus, for 2016, the $500 billion amount is multiplied by the ratio of the latest estimate of GDP for 2014 over the latest estimate of GDP for 2013.

Effective Date

The proposal applies to calendar quarters beginning after December 31, 2014.

5. Clarification of orphan drug exception to annual fee on branded prescription pharmaceutical manufacturers and importers (sec. 7005 of the discussion draft)

Present Law

An annual fee is imposed on covered entities engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program. Fees collected are credited to the Medicare Part B trust fund.

The aggregate annual fee imposed on all covered entities is $3 billion for calendar years 2014 through 2016, $4 billion for calendar year 2017, $4.1 billion for calendar year 2018, and $2.8 billion for calendar year 2019 and thereafter. The aggregate fee is apportioned among the covered entities each year based on their relative share of branded prescription drug sales taken into account during the previous calendar year.

A covered entity's relative market share for a calendar year is the entity's branded prescription drug sales taken into account during the preceding calendar year as a percentage of the aggregate branded prescription drug sales of all covered entities taken into account during the preceding calendar year. Sales taken into account during any calendar year with respect to a

[60] Pub. L. No. 111-203. Any reference to Dodd-Frank is treated as a reference to such provision as in effect on the date of the enactment of the proposal.

[61] 12 CFR Part 246, Federal Register Volume 78, no. 164, Friday, August 23, 2013, pp. 52391-52405.

covered entity is: (1) zero percent of sales not more than $5 million; (2) 10 percent of sales over $5 million but not more than $125 million; (3) 40 percent of sales over $125 million but not more than $225 million; (4) 75 percent of sales over $225 million but not more than $400 million; and (5) 100 percent of sales over $400 million.

A covered entity is any manufacture or importer with gross receipts from branded prescription drug sales. All persons treated as a single employer under section 52(a) or (b) or under section 414(m) or 414(o) are treated as a single covered entity. In applying the single employer rules under 52(a) and (b), foreign corporations are not excluded. If more than one person is liable for payment of the fee, all such persons are jointly and severally liable for payment of such fee.

Branded prescription drug sales are sales of branded prescription drugs made to any specified government program, or pursuant to coverage under any such program. The term branded prescription drugs includes any drug which is subject to section 503(b) of the Federal Food, Drug, and Cosmetic Act and for which an application was submitted under section 351(a) of such Act. Branded prescription drug sales do not include sales of any drug or biological product with respect to which an orphan drug tax credit was allowed for any taxable year under section 45C. The exception for orphan drug sales does not apply to any drug or biological product after such drug or biological product is approved by the Food and Drug Administration for marketing for any indication other than the rare disease or condition with respect to which the section 45C credit was allowed.

Specified government programs include: (1) the Medicare Part D program under part D of title XVIII of the Social Security Act; (2) the Medicare Part B program under part B of title XVIII of the Social Security Act; (3) the Medicaid program under title XIX of the Social Security Act; (4) any program under which branded prescription drugs are procured by the Department of Veterans Affairs; (5) any program under which branded prescription drugs are procured by the Department of Defense; or (6) the TRICARE retail pharmacy program under section 1074g of title 10, United States Code.

For purposes of procedure and administration, the fees are treated in the same manner as those excise taxes identified in subtitle F, "Procedure and Administration" for which the only avenue for judicial review is a civil action for refund. Thus, the fees may be assessed and collected using the procedures in subtitle F without regard to the restrictions on assessment in section 6213.

The fee is required to be paid no later than an annual payment date determined by the Secretary of the Treasury, but in no event later than September 30th each calendar year.

For purposes of section 275, relating to the nondeductibility of specified taxes, the fee is considered to be a nondeductible tax described in section 275(a)(6).

Description of Proposal

The proposal modifies the exception for orphan drugs from the computation of branded prescription drug sales. The proposal retains the exception for orphan drug sales for a drug or biological product with respect to which an orphan drug tax credit was allowed for any taxable year under section 45C (as in effect before its repeal by the Tax Reform Act of 2014). Additionally, the proposal exempts from the computation of branded prescription drug sales, a sale of any drug or biological product which is approved or licensed by the Food and Drug Administration for marketing solely for one or more rare diseases or conditions. These exceptions do not apply to the sale of any drug or biological product after such drug or biological product is approved by the Food and Drug Administration for marketing for any indication other than the treatment of a rare disease or condition.

The proposal incorporates the present law section 45C definition of rare disease or condition, thus under the proposal a rare disease or condition is any disease or condition which (A) affects less than 20,000 persons in the United States, or (B) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States a drug for such disease or condition will be recovered from sales in the United States of such drug.[62]

Under present law, the determination of whether a disease or condition is a rare disease or condition is made on the basis of the facts and circumstances as of the date the drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act. For purposes of the proposal, the determination with regard to a drug or biological product not so designated will be made based on the facts and circumstances as of the date the drug or biological product is approved or licensed by the Food and Drug Administration for marketing for the treatment of a rare disease or condition.

Effective Date

The proposal applies to the annual fee imposed under section 9008 of PPACA with annual dates after 2013.

[62] This definition is the same as originally used in section 9008 of the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148; however, section 9008 of PPACA relied on the definition of rare disease or condition found in section 45C(d)(1) which is repealed under another section of this discussion draft.