

**DESCRIPTION OF H.R. 6756, THE
“AMERICAN INNOVATION ACT OF 2018”**

Scheduled for Markup
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HOUSE COMMITTEE ON WAYS AND MEANS
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CONTENTS

	<u>Page</u>
INTRODUCTION	1
A. Simplification and Expansion of Deduction for Start-Up and Organizational Expenditures	2
B. Preservation of Start-Up Net Operating Losses and Tax Credits after Ownership Change	4

INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on September 13, 2018, of H.R. 6756, the “American Innovation Act of 2018.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 6756, the “American Innovation Act of 2018,”* (JCX-76-18), September 12, 2018. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

A. Simplification and Expansion of Deduction for Start-Up and Organizational Expenditures

Present Law

In the taxable year in which a taxpayer begins an active trade or business, the taxpayer may elect to deduct up to \$5,000 of start-up expenditures.² In addition, a taxpayer that is a corporation or a partnership may separately elect to deduct up to \$5,000 of organizational expenditures.³ In each case, however, the \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds \$50,000.⁴ Any remaining start-up expenditures or organizational expenditures may be amortized ratably over a period of 180 months, beginning with the month in which the active trade or business begins.⁵ A taxpayer is deemed to make an election to deduct and amortize start-up or organizational expenditures for the applicable taxable year, unless the taxpayer affirmatively elects to capitalize such amounts on a timely-filed (including extensions) Federal income tax return.⁶ Capitalized amounts are recovered when the business is sold, exchanged, or otherwise disposed of before the end of the 180-month amortization period.⁷

Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began.⁸ Organizational expenditures are expenditures that are incident to the creation of a corporation or the organization of a partnership, are chargeable to capital, and would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.⁹

Description of Proposal

Under the proposal, the rules for start-up expenditures (section 195) and organizational expenditures (sections 248 and 709(b)) are consolidated into a single provision.¹⁰ A taxpayer

² Sec. 195(b)(1)(A).

³ Secs. 248(a)(1) and 709(b)(1)(A).

⁴ Secs. 195(b)(1)(A)(ii), 248(a)(1)(B), and 709(b)(1)(A)(ii).

⁵ Secs. 195(b)(1)(B), 248(a)(2), and 709(b)(1)(B).

⁶ Treas. Reg. secs. 1.195-1(b), 1.248-1(c), and 1.709-1(b)(2).

⁷ Secs. 195(b)(2) and 709(b)(2). See also Treas. Reg. sec. 1.709-1(b)(3) and *Kingsford Co. v. Commissioner*, 41 T.C. 646 (1964).

⁸ Sec. 195(c)(1).

⁹ Secs. 248(b) and 709(b)(3).

¹⁰ The definitions of start-up and organizational expenditures are unchanged by the proposal, as is the requirement to capitalize partnership syndication fees under section 709(a).

may elect¹¹ to deduct up to \$20,000 of the aggregate amount of start-up and organizational expenditures in the taxable year in which the active trade or business begins.¹² The \$20,000 amount is reduced (but not below zero) by the amount by which the aggregate amount of start-up and organizational expenditures exceeds \$120,000.¹³ The \$20,000 and \$120,000 amounts are adjusted for inflation in taxable years beginning after 2019. Any remaining start-up and organizational expenditures must be amortized ratably over the 180-month period beginning with the month in which the active trade or business begins.

In the case of any partnership, corporation, or disregarded entity that is completely liquidated by the taxpayer before the end of the 180-month period, any unamortized amounts may be deducted to the extent allowable under section 165. In the case of any active trade or business which is completely disposed of or discontinued by the taxpayer before the end of the 180-month period, any unamortized start-up expenditures may be deducted to the extent allowable under section 165.¹⁴

Effective Date

The proposal applies to start-up and organizational expenditures paid or incurred in connection with active trades or businesses which begin in taxable years beginning after December 31, 2018.

¹¹ In the case of a partnership or S corporation, the election is made (and the proposal is applied) at the entity level. In the case of a disregarded entity, the proposal is applied in the same manner as if such disregarded entity were a corporation.

¹² In the case of organizational expenditures with respect to any corporation or partnership, the term “active trade or business” means the first active trade or business carried on by such corporation or partnership.

¹³ For example, assume that Corporation X, a calendar year taxpayer, incurs \$100,000 of start-up expenditures and \$30,000 of organizational expenditures that relate to an active trade or business that begins on July 1, 2019. On its 2019 tax return, Corporation X may elect to deduct \$10,000 ($\$20,000 - (\$130,000 - \$120,000)$) plus the portion of the remaining \$120,000 that is allocable to July through December of 2019 ($\$120,000/180$ months \times 6 months = \$4,000). Thus, Corporation X’s total deduction under section 195 for 2019, the year in which its active trade or business begins, is \$14,000 (\$10,000 deduction + \$4,000 amortization deduction). Corporation X may amortize the remaining \$116,000 ratably over the remaining 174 months.

¹⁴ For purposes of the disposition rule, the amount treated as unamortized start-up expenditures equals the aggregate amount of unamortized start-up and organizational expenditures multiplied by the ratio that (1) the amount of start-up expenditures taken into account in determining the deduction under section 195(b)(1) bears to (2) the aggregate amount of start-up and organizational expenditures so taken into account. For example, continuing the example in footnote 13, assume that on June 30, 2024, Corporation X completely discontinues its initial trade or business for purposes of section 165, but remains in existence. Corporation X has \$80,000 of unamortized start-up and organizational expenditures on such date. Corporation X may deduct \$61,538 of unamortized start-up expenditures in 2024 ($\$80,000 \times (\$100,000/\$130,000)$), but must continue to amortize the remaining \$18,462 of unamortized organizational expenditures over the remaining 120 months. Thus, Corporation X’s total deduction under section 195 for 2024, the year in which its trade or business is discontinued, is \$66,461 (section 165 loss deduction of \$61,538 + amortization deduction of \$4,923 (*i.e.*, the \$4,000 amortization deduction for start-up and organizational expenditures from January 1, 2024, through June 30, 2024, plus the \$923 amortization deduction for organizational expenditures from July 1, 2024, through December 31, 2024)).

B. Preservation of Start-Up Net Operating Losses and Tax Credits after Ownership Change

Present Law

Net operating losses

Section 382(a) limits the extent to which a corporation that experiences an ownership change may offset taxable income after the ownership change with losses attributable to the period before the ownership change. Specifically, following an ownership change, a new loss corporation's taxable income may be offset by pre-change losses from an old loss corporation only to the extent of the section 382 limitation (discussed below).¹⁵ A pre-change loss is (1) any net operating loss carryforward of an old loss corporation to a taxable year ending with an ownership change or in which an ownership change occurs, and (2) any net operating loss of an old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before such change date.¹⁶ Any loss that is not a pre-change loss is not limited by section 382(a).¹⁷

The section 382 limitation is determined by multiplying the value of the old loss corporation immediately before the ownership change by the long-term tax-exempt interest rate.¹⁸ If the section 382 limitation for a post-change year exceeds the taxable income of the new loss corporation for such year which was offset by pre-change losses, the section 382 limitation for the next post-change year is increased by the amount of such excess.¹⁹

A loss corporation is a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which an ownership change occurs.²⁰ An old loss corporation is a corporation with respect to which there is an ownership change and which was a

¹⁵ Sec. 382(a). However, if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the two-year period beginning on the change date, the section 382 limitation for any post-change year is generally zero. See sec. 382(c).

¹⁶ Sec. 382(d)(1).

¹⁷ Special rules apply to built-in gains and losses and section 338 gains. See sec. 382(h); Notice 2003-65, 2003-2 C.B. 747; Notice 2018-30, 2018-21 I.R.B. 610. Special rules also apply to financially troubled corporations, discussed below.

¹⁸ Sec. 382(b)(1). The long-term tax-exempt rate is the highest of the adjusted Federal long-term rates in effect for any month in the three-calendar-month period ending with the calendar month in which the change date occurs. Sec. 382(f)(1).

¹⁹ Sec. 382(b)(2).

²⁰ Sec. 382(k)(1). A loss corporation also includes any corporation that entitled to use a carryforward of disallowed interest under section 381(c)(20), and generally includes any corporation with a net unrealized built-in loss. Treasury Regulation section 1.382-2(a)(1) contains additional description of when a corporation qualifies as a loss corporation.

loss corporation before the ownership change.²¹ A new loss corporation is a corporation which is a loss corporation after an ownership change.²²

An ownership change generally is defined as an increase by more than 50 percentage points in the percentage of stock of a loss corporation that is owned by any one or more five-percent shareholders²³ within a three-year period.²⁴ Treasury regulations generally provide that this measurement is to be made as of any testing date, which is any date on which the ownership by one or more persons who were or who become five-percent shareholders changes.²⁵

Section 382(l)(5) provides rules that limit section 382's application to ownership changes that occur in the context of a title 11 or similar case. These rules generally provide that the use of pre-change losses is not limited by section 382(a) where the old loss corporation is under the jurisdiction of a court in a title 11 or similar case immediately before the ownership change and the shareholders and creditors of the old loss corporation immediately before the ownership change own (after the ownership change) at least 50 percent of the total voting power of the stock of the new loss corporation and at least 50 percent of the total value of the stock of the new loss corporation.²⁶ Among other things, these rules provide that if, during the two-year period immediately following an ownership change meeting the criteria described in the previous sentence, an ownership change of the new loss corporation occurs, the exception described in the previous sentence does not apply and the section 382 limitation with respect to the second ownership change for any post-change year after the second ownership change is zero.²⁷

²¹ Sec. 382(k)(2).

²² Sec. 382(k)(3).

²³ The term "5-percent shareholder" means any person holding five percent or more of the stock of the corporation at any time during the testing period. Sec. 382(k)(7). Determinations of the percentage of stock of a corporation held by any person are made on the basis of value. Sec. 382(k)(6)(C).

²⁴ Sec. 382(g) and (i).

²⁵ See Treas. Reg. sec. 1.382-2(a)(4)(i) (providing that, generally, a loss corporation is required to determine whether an ownership change has occurred immediately after any owner shift, or issuance or transfer of certain options with respect to stock of the loss corporation that are treated as exercised, and defining a "testing date" as "each date on which a loss corporation is required to make a determination of whether an ownership change has occurred"). All computations of increases in percentage ownership are to be made as of the close of the testing date. Treas. Reg. sec. 1.382-2(a)(4)(i). A loss corporation must include a statement on or with its Federal income tax return for each taxable year that it is a loss corporation in which an event described in Temporary Treasury Regulation section 1.382-2T(a)(2) occurs. Treas. Reg. sec. 1.382-11(a). The statement must include: (1) the date(s) of any owner shifts, equity structure shifts, or other transactions described in Temporary Treasury Regulation Section 1.382-2T(a)(2)(i), (2) the date(s) on which any ownership change(s) occurred, and (3) the amount of any attributes described in Treasury Regulation Section 1.382-2(a)(1)(i) that caused the corporation to be a loss corporation. *Ibid.*

²⁶ Sec. 382(l)(5)(A).

²⁷ Sec. 382(l)(5)(D).

Section 382(l)(6) provides that in an ownership change involving a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case that fails to meet the criteria described in the previous paragraph, or in an ownership change involving an exchange of debt for stock in a title 11 or similar case, the value of the old loss corporation used for purposes of calculating the section 382 limitation must reflect any increase in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.

Tax credits

Section 383 imposes similar limitations to those imposed by section 382(a) on the use of carryforwards of unused general business credits, alternative minimum tax credits, foreign tax credits, and net capital loss carryforwards. With regard to unused general business credits, section 383 and the regulations thereunder limit the amount of regular tax liability that can be offset by excess credits (referred to in the Treasury regulations as "pre-change credits") of the new loss corporation.²⁸ Use of pre-change credits absorbs the section 383 credit limitation.²⁹ Once the section 383 credit limitation has been fully absorbed, no more pre-change credits may be used.³⁰ Any unused general business credit that is not a pre-change credit is not limited by section 383 or the regulations thereunder.

Explanation of Proposal

The proposal amends sections 382 and 383 to permit the pre-change net operating loss carryforwards, net operating losses, general business credit carryforwards, and general business credits of a start-up business to be available for use in a post-change year without limitation by sections 382(a) and 383.

Start-up losses under section 382

With regard to section 382, the proposal generally reduces a new loss corporation's pre-change losses by the portion of the old loss corporation's net operating loss carryforwards and net operating losses that are attributable to a start-up business of the old loss corporation.³¹ Specifically, in the case of any pre-change net operating loss carryforward which arose in any start-up period taxable year (defined below), the amount of such net operating loss carryforward

²⁸ Treas. Reg. sec. 1.383-1(b).

²⁹ The section 383 credit limitation is defined as the excess of (1) the new loss corporation's regular tax liability for the post-change year over (2) the new loss corporation's regular tax liability for the post-change year computed, for this purpose, by allowing as an additional deduction an amount equal to the section 382 limitation remaining after reduction for pre-change losses and pre-change capital losses under sections 382 and 383 (and the regulations thereunder). See Treas. Reg. sec. 1.383-1(c)(6); see generally sec. 383(a).

³⁰ Treas. Reg. sec. 1.383-1(d)(1).

³¹ However, the proposal does not apply for purposes of including the carryover of disallowed business interest in the corporation's pre-change loss under section 382(d)(1) and (3).

otherwise taken into account for purposes of calculating the new loss corporation's pre-change loss is reduced by the net start-up loss (defined below) determined with respect to the start-up trade or business. In a similar manner, pre-change losses are also reduced by any net operating loss incurred in the year of the ownership change to the extent such loss is attributable to a start-up business in the period on or before the change date. By reducing pre-change losses, the proposal reduces the total amount of losses that are limited by section 382(a).

A start-up period taxable year is any taxable year of the old loss corporation which (1) begins before the close of the three-year period beginning on the date on which any trade or business of such corporation begins as an active trade or business³² and (2) ends after September

³² The beginning of an active trade or business is the same under the proposal as under present-law section 195(c)(2) without regard to subparagraph (B) thereof. (While section 195 is modified elsewhere in the bill, those changes do not affect the meaning of the beginning of active trade or business under section 195.) Thus, the three-year period described in the proposal begins on the same date that triggers allowance of a deduction under section 195(b)(1)(A). The Senate Finance Committee Report describing what ultimately became section 195 defined that concept as follows:

Generally, it is anticipated that the definition of when a business begins is to be made in reference to the existing provisions for the amortization of organizational expenditures (Code secs. 248 and 709). Generally, if the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

See Senate Finance Committee Report to accompany H.R. 7956, Miscellaneous Revenue Act of 1980, S. Rep. No. 96-1036 (96th Cong., 2d Sess.), November 25, 1980, p. 14. As the Senate Finance Committee Report states, this is similar to the concept referred to in section 248(a)(2) and defined in Treasury regulations as follows:

The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

See Treas. Reg. sec. 1.248-1(d); see also Treas. Reg. sec. 1.709-2(c) (echoing the distinctions above and explaining that "[t]he term 'operating assets', as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition"); *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir. 1965) (holding that trade or business has begun when the taxpayer has "begun to function as a going concern and performed those activities for which it was organized"). The Internal Revenue Service has cited *Richmond Television* in interpreting the active trade or business requirement under section 195. See, e.g., Tech. Adv. Mem. 9310001, November 4, 1992; Tech. Adv. Mem. 9414004, December 17, 1993.

10, 2018.³³ Start-up period taxable years may predate the beginning of active trade or business, meaning deductible expenditures paid or incurred in connection with a trade or business prior to the beginning of active trade or business may be treated as paid or incurred in a start-up period taxable year with respect to such trade or business.³⁴

Generally, a net start-up loss is the portion of the old loss corporation's net operating loss carryforward from a particular year that is attributable to activities of a start-up business in that year. Specifically, the net start-up loss with respect to a start-up business for any start-up period taxable year is the amount that bears the same ratio to the net operating loss carryforward which arose in such year as (1) the net operating loss (if any) which would have been determined for such taxable year if only items of income, gain, deduction, and loss properly allocable to the start-up trade or business were taken into account, bears to (2) the amount of the net operating loss determined for such taxable year. If the ratio described in the previous sentence is greater than one, the ratio shall be deemed to equal one.

Any net operating loss incurred prior to the ownership change date in the year of change is treated similarly to net operating loss carryforwards to the taxable year ending with the ownership change or in which the change date occurs, after proper allocation of such net operating loss and any net start-up loss to the period in such year on or before the change date.³⁵ For example, consider Corporation X, which undergoes an ownership change. In the year of change (which is also a start-up period taxable year), Corporation X has a net start-up loss of \$100, \$50 of which is allocable to the period on or before the change date. In this example, Corporation X's pre-change losses subject to limitation under section 382(a) would be reduced by \$50.

In the case of any start-up period taxable year which ends after the close of the three-year period beginning on the date an active trade or business begins, the net start-up loss with respect to such trade or business for such year is the same proportion of such loss as the proportion of such taxable year on or before the close of such period. For example, consider Corporation Y, a calendar year taxpayer that begins an active trade or business on June 30, 2019. If Corporation Y has a net start-up loss for tax year 2022 and later undergoes an ownership change, Corporation Y's pre-change losses would be reduced by half of the net start-up loss for 2022.

In the event that the old loss corporation starts more than one trade or business in a timeframe that causes a single taxable year of the old loss corporation to be a start-up period taxable year with respect to more than one trade or business, the proposal applies separately to each trade or business, and the proposal's aggregate reduction of pre-change losses for any

³³ By requiring that the start-up taxable year end after September 10, 2018, the proposal does not apply to expenses incurred in taxable years ending on or prior to September 10, 2018.

³⁴ For example, a taxpayer could have expenses in connection with a trade or business under section 174 prior to beginning active trade or business.

³⁵ Section 382(d)(1)(B) requires allocation of the net operating loss to the period on or before the change date.

taxable year of the old loss corporation cannot exceed the old loss corporation's net operating loss carryforward with respect to that year.

If the new loss corporation does not continue the start-up trade or business at all times during the two-year period beginning on the change date, the proposal does not apply with respect to such trade or business.

The proposal also provides that it does not apply in the event of an ownership change described in section 382(l)(5)(D) (*i.e.*, an ownership change that occurs during the two-year period following an ownership change in a title 11 or similar case that meets the criteria of section 382(l)(5)(A)), nor does it apply to an ownership change to which section 382(l)(6) applies (*i.e.*, certain insolvency transactions).

Start-up excess credits under section 383

The proposal generally permits unused general business credits earned by a start-up business prior to an ownership change to be used in a post-change year without limitation by section 383. Using the same definition of a start-up period taxable year as above, the proposal reduces the amount of excess credits subject to limitation under section 383 by the amount of any start-up excess credit earned in any start-up period taxable year.³⁶ A start-up excess credit with respect to a start-up business for any start-up period taxable year is the amount which bears the same ratio to the unused general business credit which arose in such taxable year as (1) the amount of the general business credit which would have been determined for such taxable year if only credits properly allocable to the start-up trade or business were taken into account, bears to (2) the amount of the general business credit determined for such taxable year. By reducing excess credits, the proposal reduces the total amount of credits that are limited by section 383.

Rules similar to those provided by the proposal under section 382 apply to (1) the last taxable year in the start-up period, (2) credits arising in the year of ownership change, (3) taxable years which are start-up period taxable years with respect to more than one trade or business, and (4) the two-year continuity of business requirement.

Effective Date

The proposal is effective for taxable years ending after September 10, 2018.

Transition rules provide that the proposal does not apply to any active trade or business that begins on or before September 10, 2018.

³⁶ As described above, the regulations under section 383 use the concept of "pre-change credits" rather than excess credits. The proposal alters the Code, and so uses the Code's approach; the intent is that the rule for reducing excess credits should apply to the calculation of pre-change credits under Treasury regulation section 1.383-1.