DESCRIPTION OF H.R. 7024, THE "TAX RELIEF FOR AMERICAN FAMILIES AND WORKERS ACT OF 2024"

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HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup for January 19, 2024, a markup of H.R. 7024, the "Tax Relief for American Families and Workers Act of 2024." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of this bill.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 7024, the "Tax Relief for American Families and Workers Act of 2024"* (JCX-2-24), January 17, 2024. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references in the document are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise stated.

I. TAX RELIEF FOR WORKING FAMILIES

Present Law

In general

Taxpayers are allowed a child tax credit of $2,000 for each qualifying child.[2] The aggregate amount of otherwise allowable child tax credit is phased out for taxpayers with income over a threshold amount of $400,000 for taxpayers filing jointly and $200,000 for all other taxpayers.[3] The otherwise allowable child tax credit amount is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income ("AGI") over the applicable threshold amount. For purposes of this limitation, modified AGI means AGI increased by any amount excluded from gross income under section 911 (foreign earned income exclusion), 931 (exclusion of income for a bona fide resident of American Samoa), or 933 (exclusion of income for a bona fide resident of Puerto Rico).[4]

Generally, for purposes of the child tax credit, a qualifying child is a qualifying child, as defined in section 152(c), who is under the age of 17.[5] Only a child who is a U.S. citizen, national, or resident may be a qualifying child; citizens of contiguous countries who are not U.S. citizens, nationals, or residents are ineligible under the child tax credit definition of qualifying child.[6]

The name and social security number ("SSN") of the qualifying child must appear on the return, and the SSN must be issued before the due date for filing the return.[7] The SSN also must be issued to a citizen or national of the United States or pursuant to a provision of the Social Security Act relating to the lawful admission for employment in the United States.[8] The TIN of the taxpayer must be issued on or before the due date for filing the return.[9]

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[2] Sec. 24(a), (h)(2). For taxable years beginning after December 31, 2025, the amount of the credit is $1,000 for each qualifying child.

[3] Sec. 24(b), (h)(3). For taxable years beginning after December 31, 2025, the modified AGI threshold amounts at which the credit begins to phase out are $75,000 for individuals who are not married, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.

[4] Sec. 24(b)(1).

[5] Sec. 24(c)(1).

[6] Sec. 24(c)(2).

[7] Sec. 24(h)(7). For taxable years beginning after December 31, 2025, the child tax credit may be claimed if the taxpayer identification number ("TIN") of the qualifying child, rather than the SSN of the child, appears on the return. Sec. 24(e)(1).

[8] See sec. 205(c)(2)(B)(i)(I) (or that portion of subclause (III) that relates to subclause (I)) of the Social Security Act.

[9] Sec. 24(e)(2).

Partial refundability and calculation of additional child tax credit

The child tax credit is generally a nonrefundable tax credit taken against income tax liability. The credit is allowable against both the regular tax and the alternative minimum tax.[10]

In some circumstances, all or a portion of the otherwise allowable credit is treated as a refundable credit (the "additional child tax credit").[11] The credit is treated as refundable in an amount equal to 15 percent of earned income in excess of $2,500 (the "earned income formula").[12] Earned income generally has the same definition as for purposes of the earned income tax credit and is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings.[13] For purposes of the additional child tax credit, only items taken into account in computing taxable income are treated as earned income.[14] However, combat pay that is excluded from gross income under section 112 is also taken into account.

A taxpayer with three or more qualifying children may determine the additional child tax credit using the "alternative formula," if this formula results in a larger additional child tax credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income tax credit.[15]

The maximum amount of the additional child tax credit per qualifying child ($1,600 for 2023 and $1,700 for 2024)[16] is indexed for inflation, although the amount may not exceed the $2,000 amount of the nonrefundable child tax credit.[17] Any adjustment for inflation is rounded down to the next lowest multiple of $100.

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[10] Sec. 26(a).

[11] Sec. 24(d).

[12] Sec. 24(d)(1)(B)(i), (h)(6). For taxable years beginning after December 31, 2025, the earned income threshold for the refundable child tax credit is $3,000.

[13] Sec. 32(c)(2).

[14] Sec. 24(d)(1)(B)(i). For example, some ministers' parsonage allowances are considered self-employment income, see section 1402(a)(8), and thus are considered earned income for purposes of computing the EITC, but they are excluded from gross income for income tax purposes and thus are not considered earned income for purposes of the additional child tax credit.

[15] Sec. 24(d)(1)(B)(ii).

[16] Rev. Proc. 2022-38, 2022-45 I.R.B. 445. and Rev. Proc. 2023-34. 2023-48 I.R.B. 1287.

[17] Sec. 24(h)(5). The nonrefundable portion of the child tax credit is not adjusted for inflation. For taxable years beginning after December 31, 2025, there is no separately stated maximum amount of the additional child tax credit; however, the refundable credit may not exceed the total amount of the credit of $1,000 for taxable years beginning after December 31, 2025.

Withholding

Chapter 24 of the Code provides rules for employers to deduct and withhold amounts from employee wages for the payment of income tax. Under rules determined by the Secretary, an employee may be permitted one or more withholding allowances that reduces the amount of income tax withholding. A taxpayer's withholding allowances may take into account the number of children in respect of whom it is reasonably expected that the taxpayer is eligible for a child tax credit.[18]

Credit for other dependents

An individual is allowed a $500 nonrefundable credit for each dependent of the taxpayer as defined in section 152 other than a qualifying child as defined for purposes of the child tax credit.[19]

Application of the child tax credit in the territories of the United States

The three mirror Code territories (Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands) have, under their mirror Codes, a child tax credit identical to that in the Internal Revenue Code. A resident of one of these territories claims the child tax credit on the income tax return filed with the territory's revenue authority.

Mirror Code territories

The Secretary is directed to make payments to each of Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands in an amount equal to the loss in revenue by reason of the application of the child tax credit to the territory's mirror Code for the taxable year.[20] This amount is determined by the Secretary based on information provided by the government of the territory.

No child tax credit under the Internal Revenue Code is permitted for any resident of a mirror Code territory with respect to whom a child tax credit is allowed against income taxes of the territory.[21]

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[18] Sec. 3402(f)(1)(C).

[19] An individual who is a qualifying child for purposes of the dependent rules under section 152, but not a qualifying child for purposes of the child tax credit (*e.g.*, a child who is age 17 or 18, a full-time student under age 24, or a child without a valid SSN) is eligible to be a qualifying dependent for purposes of the $500 nonrefundable credit for other dependents. For taxable years beginning after December 31, 2025, there is no tax credit for other dependents.

[20] Sec. 24(k)(1).

[21] Sec. 24(k)(2).

Puerto Rico

Bona fide residents of Puerto Rico may claim an additional child tax credit up to the maximum amount[22] from the U.S. Treasury under the alternative formula, but determined without regard to the three-child limitation, by filing a return with the Internal Revenue Service ("IRS").[23]

Residents of Puerto Rico claim the additional child tax credit under the alternative formula by filing a Form 1040-SS or Form 1040-PR with the IRS.

American Samoa

The Secretary is directed to make payments to American Samoa in an amount estimated by the Secretary as being equal to the aggregate benefits that would have been provided to residents of American Samoa if the U.S. child tax credit had been in effect in American Samoa (and had been applied as if American Samoa were the United States) in that taxable year.[24]

The provision prohibits the Secretary from making these payments unless American Samoa has a plan approved by the Secretary to promptly distribute the payments to its residents. For years with respect to which American Samoa has an approved plan, no child tax credit under the Internal Revenue Code is permitted for any person who is eligible for a payment under the plan. If American Samoa does not have a plan in place for a taxable year, a bona fide resident of American Samoa may claim a child tax credit by filing a return with the IRS under rules similar to those for Puerto Rico, described above.

Temporary earned income lookback for certain disasters

Congress has at times enacted taxpayer favorable rules for determining earned income for purposes of calculating the additional child tax credit for taxpayers affected by specific natural disasters.[25]

Most recently, Division Q of Public Law 116-94, the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (the "2019 Disaster Act"), allows qualified individuals to elect to use earned income for the preceding taxable year instead of earned income for the applicable taxable

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[22] This amount is $1,600 for taxable years beginning in 2023 and $1,700 for taxable years beginning in 2024. Rev. Proc. 2022-38, 2022-45 I.R.B. 445. and Rev. Proc. 2023-34. 2023-48 I.R.B. 1287.

[23] Sec. 24(k)(2)(B).

[24] Sec. 24(k)(3).

[25] See, *e.g.*, sec. 204(c) of Pub. L. No. 116-94 (Hurricanes Florence and Michael); sec. 20104(c) of Pub. L. No. 115-123 (certain California wildfires); sec. 504(c) of Pub. L. No. 115-63 (Hurricanes Harvey, Irma, and Maria); and former sec. 1400S(d) (Hurricanes Katrina, Rita, and Wilma).

year to calculate the additional child tax credit, if earned income for the applicable taxable year is less than earned income for the preceding taxable year.[26]

A "qualified individual" is an individual whose principal place of abode at any time during the incident period of any qualified disaster was located in the qualified disaster area, and such individual was displaced from such principal place of abode because of such qualified disaster, or in the qualified disaster zone.[27]

A "qualified disaster area" refers to an area with respect to which a major disaster has been declared by the President during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of enactment of the 2019 Disaster Act,[28] under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, (the "Stafford Act"),[29] if the incident period of the disaster with respect to which the declaration is made begins on or before the date of enactment of the 2019 Disaster Act.[30] A "qualified disaster zone" refers to any portion of any qualified disaster area which was determined by the President, during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of enactment of the 2019 Disaster Act, to warrant individual or individual and public assistance under the Stafford Act.[31]

A "qualified disaster" is, with respect to the applicable qualified disaster area, the disaster by reason of which a major disaster was declared with respect to that area.[32]

The "incident period" is, with respect to the applicable qualified disaster, the period specified by the Federal Emergency Management Agency as the period during which the disaster occurred, except that the period is not treated as beginning before January 1, 2018, or ending after the date which is 30 days after the date of enactment of the 2019 Disaster Act.[33]

Description of Proposal

Per-child calculation of the additional child tax credit

Under the proposal, the calculation of the additional child tax credit is temporarily made after multiplying each of the amounts determined under the earned income formula and the

[26] Sec. 204(c) of Div. Q of Pub. L. No. 116-94.

[27] Sec. 204(c)(2) of Div. Q of Pub. L. No. 116-94.

[28] The 2019 Disaster Act became law on December 20, 2019.

[29] Pub. L. No. 100-707.

[30] Sec. 201 of Div. Q of Pub. L. No. 116-94.

[31] *Ibid.*

[32] *Ibid.*

[33] *Ibid.*

alternative formula by the number of qualifying children. The additional child tax credit continues to be limited to the maximum amount of the additional child tax credit per qualifying child.

For example, consider a taxpayer with two qualifying children and earned income of $9,000. With other simplifying assumptions, under present law, this taxpayer would calculate the additional child tax credit amount to be $975.[34] Under the proposal, this taxpayer would calculate the additional child tax credit amount to be $1,950.[35]

The temporary modification of the calculation of the additional child tax credit expires for taxable years beginning after December 31, 2025.

Increase in the maximum amount of the additional child tax credit

The proposal temporarily increases the maximum amount of the additional child tax credit per qualifying child to $1,800 in 2023, $1,900 in 2024, and the full amount of the child tax credit for qualifying children ($2,000, adjusted for inflation as described below) in 2025.

The temporary increase of the maximum amount of the additional child tax credit expires for taxable years beginning after December 31, 2025.

Inflation adjustment of the child tax credit and of the 2025 additional child tax credit

The $2,000 amount of the child tax credit is temporarily indexed for inflation beginning in 2024.[36] The maximum amount of the additional child tax credit per qualifying child is also temporarily indexed for inflation, but only in 2025 and, as a result, matches the amount of the child tax credit for that year.[37] Any adjustment for inflation is rounded down to the next lowest multiple of $100.

The temporary indexing for inflation expires for taxable years beginning after December 31, 2025 when the amount of the child tax credit returns to $1,000 per qualifying child.

Rules for the determination of earned income to calculate the additional child tax credit

In calculating the additional child tax credit, the proposal temporarily allows a taxpayer to elect to use earned income for the preceding taxable year instead of earned income for the current taxable year to calculate the additional child tax credit, if earned income for the current

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[34] Under present law, the additional child tax credit is calculated by multiplying the amount of earned income that exceeds $2,500 by 15 percent. ($9,000 - $2,500) x .15 = $975.

[35] Under the proposal, the additional child tax credit is calculated by multiplying the amount of earned income that exceeds $2,500 by 15 percent and by the number of children. ($9,000 - $2,500) x .15 x 2 = $1,950.

[36] The proposal uses 2022 as the base year for this inflation calculation. Using 2022 as the base year results in one year of inflation adjustment for 2024, and two years of inflation adjustment for 2025.

[37] The proposal uses 2022 as the base year for this inflation calculation. Using 2022 as the base year results in two years of inflation adjustment for 2025.

taxable year is less than earned income for the preceding taxable year. In the case of a joint return, the earned income of the taxpayer for the preceding taxable year is the sum of the earned incomes of each spouse for such preceding taxable year.

In the case of a taxpayer electing the application of this new temporary rule, the proposal gives the IRS math error authority for an error involving an entry on a return of earned income for the preceding taxable year that is inconsistent with the amount of earned income determined by the Secretary for the preceding taxable year.

The temporary election to use prior year earned income expires for taxable years beginning after December 31, 2025.

Effective Date

The proposal changing the calculation of the additional child tax credit to a per-child earned income formula and a per-child alternative formula is effective for taxable years beginning after December 31, 2022.

The proposal increasing the maximum amount of the additional child tax credit is effective for taxable years beginning after December 31, 2022.

The proposal indexing the amount of the child tax credit in 2024 and 2025 and the additional child tax credit in 2025 for inflation is effective for taxable years beginning after December 31, 2023.

The proposal allowing the use of prior year earned income to calculate the additional child tax credit is effective for taxable years beginning after December 31, 2023.

II. AMERICAN INNOVATION AND GROWTH

1. Deduction for domestic research and experimental expenditures

Present Law

Public Law 115-97[38] modified the cost recovery rules for research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021 (with conforming changes made to sections 41 and 280C).[39] Section 174 as applicable to amounts paid or incurred in taxable years beginning before January 1, 2022, is described first below, followed by a description of section 174 as applicable to amounts paid or incurred in taxable years beginning after December 31, 2021.

Amounts paid or incurred in taxable years beginning before January 1, 2022

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[40] However, taxpayers may elect to deduct the amount of reasonable research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022, in connection with a trade or business.[41] Alternatively, taxpayers may elect to capitalize their research or experimental expenditures and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[42] Taxpayers may also elect to amortize their research or experimental expenditures over a period of 10 years.[43] Research and experimental expenditures deductible under section 174 are not required to be capitalized under

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[38] December 22, 2017.

[39] Sec. 174.

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

[41] Former secs. 174(a) and (e).

[42] Former sec. 174(b). Taxpayers that have a taxable loss or that would have a taxable loss after allowance of the deduction for research and experimental expenses, including taxpayers that incur research and experimental expenses before the start of an active trade or business, may elect to capitalize these expenses under this rule.

[43] Former secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the individual alternative minimum taxable income adjustment for research expenditures set forth in section 56(b)(2). The election under section 59(e) to amortize research or experimental expenditures over a 10-year period does not apply to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021. A technical correction may be necessary to reflect this intent.

either section 263(a)[44] or section 263A.[45] Section 174 deductions are generally reduced by the amount of the taxpayer's research credit under section 41.[46]

Research or experimental expenditures generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[47] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[48] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[49] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.[50] Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent, *etc.*), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[51] In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to the cost recovery treatment of research and experimental expenditures.[52]

Research or experimental expenditures do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with

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

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

[46] Former secs. 280C(c)(1) and (2). Taxpayers may instead elect to claim a reduced research credit amount under section 41 in lieu of reducing deductions otherwise allowed. Sec. 280C(c)(3), as effective for amounts paid or incurred in taxable years beginning before January 1, 2022.

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

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

[49] *Ibid.*

[50] *Ibid.*

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

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

literary, historical, or similar projects.[53] For purposes of section 174, quality control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.[54]

Generally, no deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[55] In addition, no deduction is allowed for any expenditure incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other minerals (including oil and gas).[56]

Amounts paid or incurred in taxable years beginning after December 31, 2021

For taxable years beginning after December 31, 2021, specified research or experimental expenditures must be capitalized and amortized ratably over a five-year period (or, in the case of expenditures that are attributable to research that is conducted outside of the United States, over a 15-year period[57]), beginning with the midpoint of the taxable year in which such specified research or experimental expenditures are paid or incurred (referred to as a half-year convention).[58] Specified research or experimental expenditures that are required to be capitalized include expenditures for software development.[59] Specified research or experimental expenditures exclude expenditures for the acquisition or improvement of land or for depreciable or depletable property used in connection with the research or experimentation and include depreciation and depletion allowances in respect of that property.[60] Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).[61]

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be

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

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

[55] Former sec. 174(c). However, depreciation and depletion allowances may be considered section 174 expenditures. *Ibid*.

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

[57] For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States. Sec. 174(a)(2)(B), by reference to sec. 41(d)(4)(F).

[58] Sec. 174(a)(2)(B).

[59] Sec. 174(c)(3).

[60] Sec. 174(c)(3).

[61] Sec. 174(c)(2).

recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.[62]

If a taxpayer's research credit under section 41 for a taxable year beginning after December 31, 2021, exceeds the amount allowed as a deduction under section 174 for that taxable year, the amount chargeable to capital account under section 174 for such taxable year must be reduced by that excess amount.[63] A taxpayer instead may elect to claim a reduced research credit amount under section 41.[64] If this election is made, the research credit is reduced by an amount equal to the amount of the credit multiplied by the highest corporate tax rate.[65]

Description of Proposal

The proposal suspends the application of section 174 for domestic research or experimental expenditures[66] paid or incurred in taxable years beginning after December 31, 2021, and before January 1, 2026. Research or experimental expenditures attributable to research that is conducted outside the United States ("foreign research or experimental expenditures") must continue to be capitalized and amortized over 15 years under section 174. The proposal provides temporary rules (in new section 174A) for domestic research or experimental expenditures.

The proposal provides that a taxpayer may:

1. deduct domestic research or experimental expenditures;

2. elect to capitalize certain domestic research or experimental expenditures and recover them ratably over the useful life of the research (but in no case over a period of less than 60 months);[67] or

3. capitalize certain domestic research or experimental expenditures to a capital account.

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[62] Sec. 174(d).

[63] Sec. 280C(c)(1).

[64] Sec. 280C(c)(2)(A).

[65] Sec. 280C(c)(2)(B).

[66] The proposal defines "domestic research or experimental expenditures" as research or experimental expenditures paid or incurred by the taxpayer in connection with its trade or business that are not attributable to foreign research (as defined by section 41(d)(4)(F)).

[67] The proposal provides that the election does not apply to property subject to the depreciation allowance under section 167 or depletion under section 611.

Similar to section 174, domestic research or experimental expenditures include software development costs.[68]

The proposal requires a taxpayer to reduce the amount it takes into account as research or experimental expenditures (whether expensed or capitalized) by the amount of the research credit allowable under section 41 ("excess research or experimental expenditures") for taxable years beginning after December 31, 2022. Taxpayers instead may elect to claim a reduced research credit amount under section 41.

The proposal treats the requirement to capitalize and amortize research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2025, as a change in the taxpayer's method of accounting for purposes of section 481. This change is treated as initiated by the taxpayer, is treated as made with the consent of the Secretary, and is applied prospectively on a cut-off basis with no corresponding catch-up adjustment to taxable income under section 481(a).

The proposal coordinates the applicable rules with the following provisions:

1. Adds domestic research or experimental expenditures to the definition of qualified research under section 41(d)(1)(A).

2. Modifies the individual adjustments to alternative minimum taxable income under section 56(b)(2) to include domestic research or experimental expenditures deducted under temporary section 174A(a).

3. Adds domestic research or experimental expenditures to the definition of qualified expenditures eligible for the election under section 59(e)(2)(B) to capitalize and amortize certain expenditures over 10 years.

4. Adds certain domestic research or experimental expenditures deducted under temporary section 174A(a) to the list of excludable capital expenditures from the qualified small issue bond limit under section 144(a)(4)(C)(iv).

5. Adds domestic research or experimental expenditures to the list of exclusions from the definition of start-up expenditures under section 195(c)(1).

6. Adds amounts deducted as domestic research or experimental expenditures to the exclusions from the capitalization rules under section 263(a)(1)(B) (for depreciable or amortizable property) and section 263A(c)(2) (for inventory).

7. Amends the rules for active business computer software royalties under section 543(d)(4)(A)(i) with respect to personal holding company income to account for domestic research or experimental expenditures.

[68] Under former section 174, taxpayers relied on Rev. Proc. 2000-50, *supra*, for the treatment of software development expenditures.

8. Modifies the allocation rules for qualified research and experimental expenditures under section 864(g)(2) to take the amortization deductions under section 174 or section 174A(c) into account for purposes of section 864 in the taxable year for which such expenditures are allowed as a deduction.

9. Clarifies that the basis of property under section 1016(a)(14) is reduced by deductions allowed under section 174 or 174A.

10. Amends the active business requirement rules for qualified small business stock under section 1202(e)(2)(B) to account for both specified research or experimental expenditures under section 174 and domestic research or experimental expenditures under section 174A.

Effective Date

The proposal applies to excess research or experimental expenditures for taxable years beginning after December 31, 2022. No inference is intended with respect to application of section 280C(c)(1) for taxable years beginning before January 1, 2023.

Notwithstanding the modification to section 280C(c)(1) for excess research or experimental expenditures, the proposal is effective for amounts paid or incurred in taxable years beginning after December 31, 2021.

The proposal provides four elective transition rules. The first transition rule allows a taxpayer to make a late election under the temporary rules to (1) capitalize and amortize domestic research or experimental expenditures over a period not less than 60 months or (2) capitalize the expenditures to a capital account for the taxpayer's first taxable year beginning after December 31, 2021. Taxpayers may effectuate the late election by filing an amended income tax return within one year of the date of enactment or in another manner as the Secretary provides.

The second transition rule allows a taxpayer that adopted a method of accounting under section 174 before the date of the proposal's enactment for the taxpayer's first taxable year beginning after December 31, 2021, to treat the application of the temporary rules as a change in method of accounting for the taxpayer's immediately succeeding taxable year. Taxpayers are allowed a catch-up adjustment to taxable income under section 481(a) on a modified cut-off basis.[69] Taxpayers may make an election to account for the catch-up adjustment ratably over two taxable years.

The third transition rule allows an eligible taxpayer to make a late election under section 59(e)(2)(B) to capitalize and amortize domestic research or experimental expenditures over 10 years for the taxpayer's first taxable year beginning after December 31, 2021. Eligible taxpayers may effectuate the late election by filing an amended income tax return within one year of the

[69] The section 481(a) adjustment only includes an adjustment for the capitalized expenditures which were not allowed as an amortization deduction by reason of section 174 prior to amendment by the proposal for the taxpayer's first taxable year beginning after December 31, 2021.

date of enactment.[70] The proposal defines an eligible taxpayer for purposes of the third transition rule as any taxpayer that does not elect the application of the second transition rule, and that filed an income tax return for the taxpayer's first taxable year beginning after December 31, 2021, before the earlier of the due date for that return and the date of enactment.

The fourth transition rule allows an eligible taxpayer to make or revoke an election under section 280C(c)(2) to claim a reduced research credit under section 41 for the taxpayer's first taxable year beginning after December 31, 2021. Eligible taxpayers may effectuate the late election or revocation by filing an amended income tax return within one year of the date of enactment.[71] The proposal defines an eligible taxpayer for purposes of the fourth transition rule as any taxpayer that filed an income tax return for the taxpayer's first taxable year beginning after December 31, 2021, before the earlier of the due date for that return and the date of enactment.

2. Extension of allowance for depreciation, amortization, or depletion in determining the limitation on business interest

Present Law

Limitation on deduction of business interest expense

Interest paid or accrued by a business generally is deductible in the computation of taxable income, subject to a number of limitations.[72] The deduction for business interest expense[73] is generally limited to the sum of (1) business interest income of the taxpayer for the

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[70] Generally, an election under section 59(e)(2)(B) must be filed no later than the date prescribed by law for filing the taxpayer's original income tax return (including extensions) for the tax year in which the amortization of the qualified expenditures subject to the election begins. See Treas. Reg. sec. 1.59-1(b)(1).

[71] Generally, an election under section 280C(c)(2) must be filed no later than the date prescribed by law for filing the taxpayer's original income tax return (including extensions). See sec. 280C(c)(2)(C).

[72] Sec. 163(a). Interest deductions limitations that are not described in this document include: denial of the deduction for the disqualified portion of the original issue discount on an applicable high yield discount obligation (sec. 163(e)(5)), denial of deduction for interest on certain obligations not in registered form (sec. 163(f)), reduction of the deduction for interest on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 (sec. 163(g)), disallowance of deduction for interest on debt with respect to certain life insurance contracts (sec. 264(a)), and disallowance of deduction for interest relating to tax-exempt income (sec. 265(a)(2)). In some circumstances, interest expense is required to be capitalized. See, *e.g.*, secs. 263A(f) (capitalization of interest incurred to produce certain tangible property) and 461(g) (prepaid interest). Section 385 also recharacterizes as equity some instruments that are purported to be indebtedness with the results that payments on the interest are treated as nondeductible dividends rather than deductible interest.

[73] Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business and does not include investment interest (within the meaning of section 163(d)). Sec. 163(j)(5). Section 163(j) applies only to business interest that would otherwise be deductible in the current taxable year, absent the application of section 163(j). Treas. Reg. sec. 1.163(j)-3(b)(1). Thus, section 163(j) applies after the application of provisions that subject interest to deferral, capitalization, or other limitation (*e.g.*, sections 163(e)(3), 163(e)(5)(A)(ii), 246A, 263A, 263(g), 267, 1277, and 1282), but before application of sections 461(l), 465, and 469. See Treas. Reg. sec. 1.163(j)-3(b)(2)-(6).

taxable year,[74] (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year (not less than zero), and (3) the floor plan financing interest[75] of the taxpayer for the taxable year.[76] Thus, other than floor plan financing interest, business interest expense in excess of business interest income is generally deductible only to the extent of 30 percent of adjusted taxable income.[77]

The limitation generally applies at the taxpayer level (although special rules apply in the case of partnerships, described below). In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.[78] The amount of any business interest expense not allowed as a deduction for any taxable year is generally treated as business interest expense paid or accrued by the taxpayer in the succeeding taxable year. This business interest expense may be carried forward indefinitely.[79]

Application to passthrough entities

In general

In the case of a partnership, the section 163(j) interest limitation is generally applied at the partnership level.[80] A partner generally must apply section 163(j) separately to any business interest expense it incurs. To prevent double counting, the business interest income and adjusted taxable income of each partner are generally determined without regard to the partner's

[74] Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business and does not include investment income (within the meaning of section 163(d)). Sec. 163(j)(6).

[75] Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness means indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired. A motor vehicle means a motor vehicle that is: (1) any self-propelled vehicle designed for transporting person or property on a public street, highway, or road; (2) a boat; or (3) farm machinery or equipment. Sec. 163(j)(9).

[76] These rules were modified for taxable years beginning in 2019 or 2020 to permit certain taxpayers to deduct more business interest than would be allowed under the rules described herein. See sec. 163(j)(10).

[77] The business interest limitation does not apply in certain cases. The business interest limitation does not apply to any taxpayer (other than a tax shelter prohibited from using the cash method under section 448(a)(3)) that meets the $25 million gross receipts test of section 448(c). At a taxpayer's election, (1) any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (referred to as an "electing real property trade or business") or (2) any farming business or any business engaged in the trade or business of a specified agricultural or horticultural cooperative (referred to as an "electing farming business") is not treated as a trade or business for purposes of the limitation. The limitation does not apply to certain regulated public utilities. See sec. 163(j)(7).

[78] See Treas. Reg. sec. 1.163(j)-4(d) (providing that a consolidated group has a single sec. 163(j) limitation and generally treating all members of the consolidated group as a single taxpayer for sec. 163(j) purposes).

[79] Sec. 163(j)(2). With respect to corporations, any carryforward of disallowed business interest of a corporation is an item taken into account in the case of certain corporate acquisitions described in section 381 and is subject to limitation under section 382. Secs. 381(c)(20) and 382(d)(3).

[80] Sec. 163(j)(4)(A)(i).

distributive share of any items of income, gain, deduction, or loss of the partnership.[81] However, in cases in which the partnership has an excess amount of business interest income, an excess amount of adjusted taxable income, or both, section 163(j) partnership items generally may support additional business interest expense deductions by the partnership's partners. Specifically, a partner's business interest deduction limitation is increased by the sum of the partner's distributive share of the partnership's excess business interest income and 30 percent of the partner's distributive share of the partnership's excess taxable income.[82]

Similar rules apply to an S corporation and its shareholders.[83]

Carryforward rules for partnerships

Special rules for the carryforward of disallowed business interest expense apply only to partnerships and their partners.[84] In the case of a partnership, the general taxpayer-level carryforward rule does not apply. Instead, any business interest expense that is not allowed as a deduction to the partnership for the taxable year (referred to as "excess business interest expense") is allocated to the partners.[85] A partner may not deduct excess business interest expense in the year in which it is allocated to a partner. A partner may deduct its share of the partnership's excess business interest expense in any future year, but only in an amount that is based on the partner's distributive share of excess business interest income and excess taxable income of the partnership the activities of which gave rise to the disallowed business interest expense carryforward.[86] Any amount that is not allowed as a deduction generally continues to be carried forward.[87]

When excess business interest expense is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of the allocation, even though the excess business interest expense does not give rise to a deduction in the year of the basis reduction.[88] The partner's deduction in a subsequent year for excess business interest expense does not reduce the partner's basis in its partnership interest. If the partner disposes of a partnership interest the basis of which has been reduced by an allocation of excess business interest expense, the partner's basis in the interest is increased immediately before the disposition by the amount by which the basis reduction exceeds any amount of excess business interest

[81] Sec. 163(j)(4)(A)(ii)(I); Treas. Reg. sec. 1.163(j)-6(e)(1).

[82] Sec. 163(j)(4)(A)(ii)(II); Treas. Reg. sec. 1.163(j)-6(e)(1).

[83] Sec. 163(j)(4)(D).

[84] Sec. 163(j)(4)(B).

[85] Sec. 163(j)(4)(B)(i)(II).

[86] Sec. 163(j)(4)(B)(ii)(I); Treas. Reg. sec. 1.163(j)-6(g)(2). See also Joint Committee on Taxation, *General Explanation of Public Law 115–97* (JCS–1–18), December 2018, pp. 175-178 (describing section 163(j)(4) as it was intended to work).

[87] Sec. 163(j)(4)(B)(ii)(II).

[88] Sec. 163(j)(4)(B)(iii)(I); Treas. Reg. sec. 1.163(j)-6(h)(2).

expense that has been treated as business interest expense paid or accrued by the partner as a result of an allocation of excess business interest income or excess taxable income by the same partnership.[89] This rule applies to both total and (on a proportionate basis) partial dispositions of a partnership interest.[90]

The special carryforward rules do not apply to S corporations or their shareholders.[91] Rather, any disallowed business interest expense is carried forward by the S corporation (as opposed to the shareholder) to the succeeding taxable year.[92]

Adjusted taxable income

For purposes of the section 163(j) interest limitation, adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; or (4) the amount of any deduction allowed under section 199A.

For taxable years beginning before January 1, 2022, adjusted taxable income also is computed without regard to any deduction allowable for depreciation, amortization, or depletion.[93] This definition of adjusted taxable income generally corresponds with the financial accounting concept of earnings before interest, taxes, depreciation, and amortization, or "EBITDA" (hereinafter referred to as the "EBITDA limitation").

For taxable years beginning after December 31, 2021, adjusted taxable income is computed to include deductions allowable for depreciation, amortization, or depletion. This definition of adjusted taxable income generally corresponds with the financial accounting concept of earnings before interest and taxes, or "EBIT."

Description of Proposal

The proposal temporarily extends the EBITDA limitation under section 163(j) to apply to taxable years beginning before January 1, 2026. For purposes of the section 163(j) interest

[89] Sec. 163(j)(4)(B)(iii)(II); Treas. Reg. sec. 1.163(j)-6(h)(3). The special rule for dispositions also applies to transfers of a partnership interest (including by reason of death) in transactions in which gain is not recognized in whole or in part. *Id*. No deduction is allowed to the transferor or transferee for any disallowed business interest resulting in a basis increase under this rule. *Id*.

[90] *Ibid*.

[91] Sec. 163(j)(4)(D).

[92] Treas. Reg. sec. 1.163(j)-6(l)(5).

[93] Sec. 163(j)(8)(A). Treasury regulations provide other adjustments to the definition of adjusted taxable income. Sec. 163(j)(8)(B); Treas. Reg. sec. 1.163(j)-1(b)(1).

deduction limitation, adjusted taxable income is computed without regard to the deduction for depreciation, amortization, or depletion for taxable years beginning before January 1, 2026.[94]

Effective Date

While the proposal generally is effective for taxable years beginning after December 31, 2023, an elective transition rule allows a taxpayer to elect to apply the EBITDA limitation under section 163(j) to taxable years beginning after December 31, 2021.

3. Extension of 100 percent bonus depreciation

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover the cost over time through annual deductions for depreciation or amortization.[95] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[96] Tangible property generally is depreciated using the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[97]

Bonus depreciation

An additional first-year depreciation deduction equal to 100 percent of the adjusted basis of qualified property is allowed for property acquired after September 27, 2017,[98] and placed in

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[94] A partnership that has already filed Form 1065, *U.S. Return of Partnership Income*, for a taxable year beginning in 2022 may have to either supersede or amend its return, or file an administrative adjustment request ("AAR") if it is subject to the Bipartisan Budget Act ("BBA") centralized partnership audit regime of sections 6221 through 6241. In general, only partnerships that are not subject to the BBA centralized partnership audit regime are able to file a superseding or amended Form 1065. Partnerships subject to those rules must instead file an AAR. See secs. 6221 and 6227. However, at times the IRS has exercised its authority under section 6031(b) and allowed BBA partnerships to instead file superseding or amended returns (while still being subject to the BBA centralized partnership audit regime). See, *e.g.*, Rev. Proc. 2021-50, 2021-49 I.R.B. 844; Rev. Proc. 2021-29, 2021-27 I.R.B. 12; Rev. Proc. 2020-23, 2020-18 I.R.B. 749; and Rev. Proc. 2019-32, 2019-33 I.R.B. 659.

[95] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.*, the taxpayer with the benefits and burdens of ownership) is entitled to claim cost recovery deductions for the property. Where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, sec. 280A.

[96] See Treas. Reg. secs. 1.167(a)-10(b), -3, -14, and 1.197-2(f). See also Treas. Reg. sec. 1.167(a)-11(e)(1)(i).

[97] Sec. 168.

[98] For a description of section 168(k) as it applies to qualified property acquired before September 28, 2017, as well as a transition rule that permits a taxpayer to elect to apply a 50-percent allowance instead of the 100-percent allowance for a taxable year that includes September 28, 2017, see Joint Committee on Taxation, *General Explanation of Public Law No. 115-97* (JCS-1-18), December 2018, pp. 115-128. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

service before January 1, 2023 (January 1, 2024 for certain property with a recovery period of at least 10 years, or certain transportation property[99] and aircraft[100]).[101] The 100-percent allowance is phased down by 20 percentage points per calendar year for property acquired after September 27, 2017, and placed in service after December 31, 2022 (after December 31, 2023, for longer production period property and certain aircraft).[102] This additional first-year depreciation is commonly referred to as "bonus depreciation." The bonus depreciation applicable percentages for qualified property acquired and placed in service after September 27, 2017 (as well as for specified plants which are planted or grafted after September 27, 2017 (described below)) are as follows.

Placed in Service Year[103]	**Bonus Depreciation Applicable Percentage**	
	Qualified Property in General/Specified Plants	**Longer Production Period Property and Certain Aircraft**
Sept. 28, 2017 – Dec. 31, 2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent[104]
2028 and thereafter	None	None

[99] Property qualifying for the extended placed-in-service date must have a recovery period of at least 10 years or constitute transportation property, have an estimated production period exceeding one year, and have 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. Sec. 168(k)(2)(B). Property defined in section 168(k)(2)(B) is hereinafter collectively referred to as "longer production period property."

[100] 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. Sec. 168(k)(2)(C).

[101] Sec. 168(k). The bonus depreciation deduction is generally subject to the rules regarding whether a cost must be capitalized under section 263A. For a description of section 263A, see Joint Committee on Taxation, *Present Law and Background Regarding the Federal Income Taxation of Small Businesses* (JCX-10-23), June 5, 2023, pp. 15-17. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[102] Sec. 168(k)(6)(A) and (B).

[103] In the case of specified plants, this is the year of planting or grafting, as discussed below.

[104] 20 percent applies to the adjusted basis attributable to its manufacture, construction, or production before January 1, 2027. The remaining adjusted basis does not qualify for bonus depreciation. 20 percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2027.

The bonus depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed in computing earnings and profits.[105] The basis of the property and the depreciation allowances in the placed in service year and later years are adjusted to reflect the bonus depreciation deduction.[106] The amount of the bonus depreciation deduction is not affected by a short taxable year.[107] A taxpayer may elect out of bonus depreciation for any class of property for any taxable year.[108] An election out of bonus depreciation may be revoked only with the consent of the Secretary.[109]

Qualified property

Property qualifying for the bonus depreciation deduction must meet the following requirements:

- The property must be:

    1. property to which MACRS applies with an applicable recovery period of 20 years or less,
    2. computer software other than computer software required to be amortized under section 197,
    3. water utility property,[110] or
    4. a qualified film, television, or live theatrical production,[111] for which a deduction otherwise would have been allowable under section 181 without regard to the dollar limitation or termination of that section,[112]

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[105] Secs. 56A(c)(13), 168(k)(2)(G), and 312(k)(3).

[106] Sec. 168(k)(1).

[107] Treas. Reg. sec. 1.168(k)-2(e)(1)(ii).

[108] For the definition of a class of property, see Treas. Reg. sec. 1.168(k)-2(f)(1)(ii). Treas. Reg. sec. 1.168(k)-2(f)(1) provides the procedures for making an election not to deduct bonus depreciation.

[109] Sec. 168(k)(7). See also Treas. Reg. sec. 1.168(k)-2(f)(5).

[110] As defined in section 168(e)(5).

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

[112] Under section 181, a taxpayer may generally elect to deduct up to $15 million of the aggregate production costs ($20 million in the case of productions in certain areas) of any qualified film, television or live theatrical production, commencing prior to January 1, 2026, in the year the costs are paid or incurred by the taxpayer, in lieu of capitalizing the costs and recovering them through depreciation allowances once the production is placed in service. The costs of the production in excess of the applicable dollar limitation are capitalized and recovered under the taxpayer's method of accounting for the recovery of such property once placed in service (*e.g.*, under section 168(k) if eligible). For a description of section 181, see Joint Committee on Taxation, *General*

- Either (i) the original use of the property must commence with the taxpayer,[113] or (ii) the property must not have been used by the taxpayer at any time before acquisition and the acquisition must meet the requirements of section 179(d)(2)(A)-(C) and (3),[114] and
- The property must be placed in service before January 1, 2027.[115]

The bonus depreciation deduction is not allowed for any property that is required to be depreciated under the alternative depreciation system ("ADS"),[116] or for listed property in respect of which the business use is not greater than 50 percent (as determined under section 280F(b)).[117]

In the case of longer production period property and certain aircraft, the property must also be acquired (or acquired pursuant to a written binding contract entered into) before January 1, 2027, and placed in service before January 1, 2028.[118] With respect to such 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 before

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Explanation of Certain Tax Legislation Enacted in the 116th Congress (JCS-1-22), February 2022, pp. 480-482. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[113] See Treas. Reg. sec. 1.168(k)-2(b)(3)(ii).

[114] Thus, used property must be purchased in an arm's length transaction. The property must not be acquired (i) from a member of the taxpayer's family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in section 267; (ii) from a person who controls, is controlled by, or is under common control with, the taxpayer; nor (iii) in a nontaxable exchange such as a reorganization. The property must not be received as a gift or from a decedent. In the case of trade-ins, like-kind exchanges, or involuntary conversions, bonus depreciation applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property. See sec. 179(d)(2)(A)-(C) and (3); Treas. Reg. secs. 1.168(k)-2(b)(3)(iii) and 1.179-4(c) and (d). A special rule applies in the case of a syndication transaction. See sec. 168(k)(2)(E)(iii); Treas. Reg. sec. 1.168(k)-2(b)(3)(vi).

[115] A qualified production is considered placed in service, and thus eligible for the bonus depreciation allowance, at the time of initial release, broadcast, or live staged performance. Sec. 168(k)(2)(H); Treas. Reg. sec. 1.168(k)-2(b)(4)(iii).

[116] See sec. 168(g) (determined without regard to an election to use ADS under section 168(g)(7)). See also Treas. Reg. sec. 1.168(k)-2(b)(2)(ii)(B). ADS is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, certain imported property covered by an Executive order, and certain property held by either a real property trade or business or a farming business electing out of the business interest limitation under section 163(j). In addition, an election to use ADS is available to taxpayers for any class of property for any taxable year. Under ADS, all property is depreciated using the straight line method and the applicable convention over recovery periods which generally are equal to the class life of the property, with certain exceptions.

[117] Sec. 168(k)(2)(D). For a description of section 280F, see Joint Committee on Taxation, *General Explanation of Public Law No. 115-97* (JCS-1-18), December 2018, pp. 128-130. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[118] Sec. 168(k)(2)(B)(i)(II) and (III).

January 1, 2027.[119] Additionally, a special rule limits the amount of costs of longer production period property eligible for bonus depreciation. With respect to this property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2027 ("progress expenditures") is eligible for the bonus depreciation deduction.[120]

Exception for certain businesses not subject to the limitation on interest expense

Qualified property eligible for the bonus depreciation deduction does not include any property which is primarily used in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.[121]

Qualified property also does not include any property used in a trade or business that has had floor plan financing indebtedness[122] if the floor plan financing interest related to the indebtedness was taken into account to increase the taxpayer's section 163(j) interest limitation under section 163(j)(1)(C).[123]

Special rules

Passenger automobiles

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 for (and for which the taxpayer does not elect out of) bonus depreciation.[124] While the underlying section 280F limitation is indexed for inflation,[125] the section 280F increase amount is not indexed for inflation.

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[119] Sec. 168(k)(2)(E)(i).

[120] Sec. 168(k)(2)(B)(ii). See also Treas. Reg. sec. 1.168(k)-2(e)(1)(iii).

[121] Secs. 168(k)(9)(A) and 163(j)(7)(A)(iv). See also Treas. Reg. sec. 1.168(k)-2(b)(2)(ii)(F).

[122] As defined in section 163(j)(9).

[123] Sec. 168(k)(9)(B). See also Treas. Reg. sec. 1.168(k)-2(b)(2)(ii)(G).

[124] Sec. 168(k)(2)(F). See Rev. Proc. 2019-13, 2019-09 I.R.B. 744, for a safe harbor method of accounting for determining depreciation deductions for passenger automobiles that qualify for bonus depreciation and are subject to the section 280F depreciation limitations.

[125] Sec. 280F(d)(7). See Rev. Proc. 2023-14, 2023-6 I.R.B. 466, for the section 280F limitations that apply to passenger automobiles placed in service during calendar year 2023.

Certain plants bearing fruits and nuts

A farming business[126] is allowed a special election in respect of certain costs of planting or grafting certain plants bearing fruits and nuts.[127] Under the election, the applicable percentage of the adjusted basis of a specified plant which is planted or grafted after September 27, 2017, and before January 1, 2027, is deductible for regular tax and alternative minimum tax purposes in the year planted or grafted by the taxpayer in the ordinary course of the taxpayer's farming business (rather than in the year the specified plant is placed in service by the taxpayer[128]), and the adjusted basis is reduced by the amount of the deduction.[129] The applicable percentage is 100 percent for specified plants planted or grafted after September 27, 2017, and before January 1, 2023, and then is phased down by 20 percentage points per calendar year beginning in 2023.[130] Thus, the applicable percentage is 80 percent for 2023, 60 percent for 2024, 40 percent for 2025, and 20 percent for 2026.

A specified plant is (i) any tree or vine that bears fruits or nuts, and (ii) any other plant that will have more than one crop or yield of fruits or nuts and which generally has a pre-productive period of more than two years from the time of planting or grafting to the time it begins bearing a marketable crop or yield of fruits or nuts.[131] A specified plant does not include any property that is planted or grafted outside of the United States. If the election is made with respect to any specified plant, the plant is not treated as qualified property eligible for bonus depreciation in the subsequent taxable year in which it is placed in service.[132] Once made, the election is revocable only with the consent of the Secretary.[133]

[126] For this purpose, the term ''farming business'' means the trade or business of farming, including the trade or business of operating a nursery or sod farm, the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots). Sec. 263A(e)(4).

[127] Sec. 168(k)(5). Treas. Reg. sec. 1.168(k)-2(f)(2) provides the procedures for making a section 168(k)(5) election.

[128] In the case of any tree or vine bearing fruits or nuts, the placed in service date generally does not occur until the tree or vine first reaches an income-producing stage. See Treas. Reg. sec. 1.46-3(d)(2). See also Rev. Rul. 80-25, 1980-1 C.B. 65; and Rev. Rul. 69-249, 1969-1 C.B. 31.

[129] Any amount deducted under this election is not subject to capitalization under section 263A. Sec. 263A(c)(7).

[130] Sec. 168(k)(6)(C).

[131] Sec. 168(k)(5)(B).

[132] Sec. 168(k)(5)(D). However, when placed in service, the remaining adjusted basis of the specified plant may be eligible for expensing under section 179.

[133] Sec. 168(k)(5)(C). See also Treas. Reg. sec. 1.168(k)-2(f)(5).

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.[134] 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 seven 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 before January 1, 2027 (January 1, 2028, in the case of longer production period property).[135]

Description of Proposal

The proposal extends the allowance of a 100-percent bonus depreciation deduction for property placed in service after December 31, 2022, and before January 1, 2026 (January 1, 2027, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after December 31, 2022, and before January 1, 2026. The proposal retains the present law 20-percent bonus depreciation deduction that is allowed for property placed in service after December 31, 2025, and before January 1, 2027 (after December 31, 2026, and before January 1, 2028, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after December 31, 2025, and before January 1, 2027.

Under the proposal, the bonus depreciation percentage rates are as follows.

Placed in Service Calendar Year[136]	Bonus Depreciation Applicable Percentage	
	Qualified Property in General/Specified Plants	Longer Production Period Property and Certain Aircraft
2023 - 2025	100 percent	100 percent
2026	20 percent	100 percent
2027	None	20 percent[137]
2028 and thereafter	None	None

Effective Date

The proposal applies to property placed in service and specified plants planted or grafted after December 31, 2022.

[134] Sec. 460.

[135] Sec. 460(c)(6).

[136] In the case of specified plants, this is the year of planting or grafting.

[137] 20 percent applies to progress expenditures incurred before January 1, 2027. 20 percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2027.

4. Increase in limitations on expensing of depreciable business assets

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[138] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[139] Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[140]

Election to expense certain depreciable business assets

Subject to certain limitations, 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.[141] The maximum amount a taxpayer may expense is $1,000,000 of the cost of qualifying property placed in service for the taxable year.[142] The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,500,000.[143]

The $1,000,000 and $2,500,000 amounts are indexed for inflation for taxable years beginning after 2018.[144] For taxable years beginning in 2023, the total amount that may be expensed is $1,160,000, and the phaseout threshold amount is $2,890,000.[145] For example, assume that during 2023 a calendar year taxpayer purchased and placed in service $4,000,000 of section 179 property. The $1,160,000 section 179(b)(1) dollar amount for 2023 is reduced by the excess section 179 property cost amount of $1,110,000 ($4,000,000 – $2,890,000). The

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[138] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.*, the taxpayer with the benefits and burdens of ownership) is entitled to claim cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, sec. 280A.

[139] See Treas. Reg. secs. 1.167(a)-10(b), -3, -14, and 1.197-2(f). See also Treas. Reg. sec. 1.167(a)-11(e)(1)(i).

[140] Sec. 168.

[141] In the case of property purchased and placed in service by a partnership (or S corporation), the determination of whether the property is section 179 property is made at the partnership (or corporate) level, and the election to expense is made by the partnership (or S corporation). Treas. Reg. sec. 1.179-1(h).

[142] Sec. 179(b)(1).

[143] Sec. 179(b)(2).

[144] Sec. 179(b)(6).

[145] Section 3.25 of Rev. Proc. 2022-38, 2022-45 I.R.B. 445.

taxpayer's 2023 section 179 expensing limitation is $50,000 ($1,160,000 – $1,110,000).[146]

In general, qualifying property is defined as depreciable tangible personal property, off-the-shelf computer software, and qualified real property[147] that is purchased for use in the active conduct of a trade or business.[148] Qualifying property excludes any property described in section 50(b) (other than paragraph (2) thereof[149]).[150]

Qualified real property includes (1) qualified improvement property[151] and (2) any of the following improvements to nonresidential real property that are placed in service by the taxpayer after the date such nonresidential real property was first placed in service: roofs; heating, ventilation, and air-conditioning ("HVAC") property;[152] fire protection and alarm systems; and security systems.[153]

Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F.[154] For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for

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[146] The taxpayer's remaining basis in the property may be eligible for bonus depreciation under section 168(k). See Treas. Reg. sec. 1.168(k)-1(a)(2)(iii).

[147] At the election of the taxpayer. Sec. 179(d)(1)(B)(ii). See sec. 3.02 of Rev. Proc. 2019-08, 2019-03 I.R.B. 347, for guidance regarding the election to treat qualified real property as section 179 property.

[148] Sec. 179(d)(1). If section 179 property is not used predominantly in a trade or business of the taxpayer at any time before the end of its recovery period, recapture rules apply. See sec. 179(d)(10) and Treas. Reg. sec. 1.179-1(e).

[149] Thus, section 179 property includes certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging (*e.g.*, beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let). See Treas. Reg. sec. 1.48-1(h).

[150] Sec. 179(d)(1) flush language. Property described in section 50(b) (other than paragraph (2) thereof) is generally property used outside the United States, property used by certain tax-exempt organizations, and property used by governmental units and foreign persons or entities (*i.e.*, certain property not eligible for the investment tax credit).

[151] As defined in sec. 168(e)(6).

[152] HVAC property includes all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes, and ducts. Treas. Reg. sec. 1.48-1(e)(2). See also sec. 3.01(1)(b)(iii)(B) of Rev. Proc. 2019-08, 2019-03 I.R.B. 347.

[153] Sec. 179(e).

[154] For a description of section 280F, see Joint Committee on Taxation, *General Explanation of Public Law 115-97* (JCS-1-18), December 2018, pp. 128-130. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

any taxable year under section 179 is $25,000 (the "sport utility vehicle limitation").[155] The $25,000 amount is indexed for inflation for taxable years beginning after 2018. For taxable years beginning in 2023, the sport utility vehicle limitation is $28,900.[156]

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 section 179).[157] Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). In the case of a partnership (or S corporation), the section 179 limitations are applied at the partnership (or corporate) and partner (or shareholder) levels.[158]

Amounts expensed under section 179 are allowed for both regular tax and alternative minimum tax purposes.[159] However, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.[160] In addition, 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 under section 179 reduce corporate earnings and profits ratably over a five-year period.[161]

An expensing election is made under rules prescribed by the Secretary.[162] In general, any election made under section 179, and any specification contained therein, may be revoked by the

[155] Sec. 179(b)(5). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

[156] Section 3.25 of Rev. Proc. 2022-38, 2022-45 I.R.B. 445.

[157] Sec. 179(b)(3). See also Treas. Reg. sec. 1.179-2(c)(6)(iv) (wages, salaries, tips, and other compensation received by a taxpayer as an employee are included in the taxpayer's aggregate amount of taxable income derived from the active conduct of a trade or business).

[158] Sec. 179(d)(8).

[159] See the Senate Finance Committee Report to Accompany H.R. 3838, Tax Reform Act of 1986, S. Rep. No. 99-313, May 29, 1985, p. 522. See also the Instructions for Form 6251, *Alternative Minimum Tax - Individuals (2022)*, p. 5.

[160] Sec. 179(d)(9).

[161] Sec. 312(k)(3)(B).

[162] Sec. 179(c)(1). Such election may be made on an amended return. See sec. 3.02 of Rev. Proc. 2017-33, 2017–19 I.R.B. 1236; and sec. 3.02 of Rev. Proc. 2019-08, 2019-03 I.R.B. 347.

taxpayer with respect to any property without the consent of the Commissioner.[163] Such revocation, once made, is irrevocable.

Description of Proposal

The proposal increases the maximum amount a taxpayer may expense under section 179 to $1,290,000 and increases the phaseout threshold amount to $3,220,000. The proposal provides that the maximum amount a taxpayer may expense for taxable years beginning after 2023 is $1,290,000 of the cost of section 179 property placed in service for the taxable year. The $1,290,000 amount is reduced (but not below zero) by the amount by which the cost of section 179 property placed in service during the taxable year exceeds $3,220,000. The $1,290,000 and $3,220,000 amounts are indexed for inflation for taxable years beginning after 2024.

For example, assume that during 2024 a calendar year taxpayer purchases and places in service $4,000,000 of section 179 property. The $1,290,000 section 179(b)(1) dollar amount for 2024 will be reduced by the excess section 179 property cost amount of $780,000 ($4,000,000 – $3,220,000 limitation). Thus, the taxpayer's 2024 section 179 limitation will be $510,000 ($1,290,000 dollar limitation – $780,000 excess). The remaining $3,490,000 ($4,000,000 – $510,000 section 179 expense) may be eligible for bonus depreciation under section 168(k).

Effective Date

The proposal applies to property placed in service in taxable years beginning after December 31, 2023.

[163] Sec. 179(c)(2).

III. INCREASING GLOBAL COMPETITIVENESS

A. The United States-Taiwan Expedited Double-Tax Relief Act

Present Law

The following discussion summarizes U.S. taxation of income from cross-border business activity, with emphasis on how the rules determine whether the income is subject to tax by the United States or another jurisdiction in either the Internal Revenue Code[164] or in bilateral agreements in which the United States agrees to relieve double taxation when its jurisdiction to tax overlaps or is in conflict with that of another jurisdiction.

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct and persons (whether natural or juridical) with a sufficient nexus to the sovereign nation. The nexus may be based on nationality (*i.e.*, a nexus based on a connection between the relevant person and the sovereign nation) or may be territorial (*i.e.*, a nexus based on a connection between the relevant conduct and the sovereign nation). These concepts have been refined and adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to tax.

1. U.S. Tax Principles Common to Inbound and Outbound Taxation

Taxes based on where activities occur, or where property is located, are source-based taxes. The United States generally taxes the U.S. trades or businesses of foreign persons and sales or other dispositions of interests in U.S. real property by foreign persons. In addition, the United States generally taxes items of income that are paid by U.S. persons to foreign persons. Most jurisdictions, including the United States, have rules for determining the source of items of income and expense in a broad range of categories, such as compensation for services, dividends, interest, royalties, and gains.

Income taxes based on a person's citizenship, nationality, or residence are residence-based taxes. The United States generally imposes residence-based taxation on U.S. persons in the year in which income is earned. For individuals and domestic entities, this results in taxing them on their worldwide income, whether derived in the United States or abroad, with limited opportunity for deferral of taxation of income earned by foreign corporations owned by U.S. shareholders. As explained below, income earned by a resident of the United States from foreign activities conducted through a foreign entity generally is subject to U.S. tax in the year earned or not at all. The United States generally taxes foreign persons on only U.S.-source income.

The United States imposes source-based taxation on U.S.-source income of nonresident alien individuals and other foreign persons. Under this system, the application of the Code differs depending on whether income arises from outbound investment (*i.e.*, foreign investments by U.S. persons) or inbound investment (*i.e.*, U.S. investment by foreign persons). While the United States taxes inbound and outbound investments differently, certain rules are common to

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[164] Unless otherwise stated, section references are to the Internal Revenue Code of 1986, as amended (the "Code").

the taxation of both, including rules relating to residency, entity classification, source determination, and transfer pricing.

Residence

The Code defines a U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, trusts and estates.[165] Partnerships and corporations are domestic if organized or created under the laws of the United States, any State, or the District of Columbia, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[166] All other partnerships and corporations (*i.e.*, those organized under the laws of foreign countries) are foreign.[167] Other jurisdictions may use factors such as situs or management and control to determine residence. As a result, legal entities may have more than one tax residence, or, in some cases, no residence. In such cases, bilateral treaties may resolve conflicting claims of residence.

Exception for corporate inversions

In certain cases, a foreign corporation that acquires a domestic corporation or partnership may be treated as a domestic corporation for Federal tax purposes.[168] This result generally applies following a transaction in which, pursuant to a plan or a series of related transactions:

1. A domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;

2. The former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (often referred to as "stock held by reason of"); and

3. The foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (the "expanded affiliated group"), does not have substantial business activities in the entity's country of organization, compared to the total worldwide business activities of the expanded affiliated group.

If the "stock held by reason of" the acquisition is less than 80 percent, but at least 60 percent of the stock of the foreign corporation, and the other requirements above are satisfied, then the foreign corporation is not treated as a domestic corporation. Instead, the foreign corporation is considered a surrogate foreign corporation for the acquired domestic company,

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[165] Sec. 7701(a)(30).

[166] Sec. 7701(a)(4) and (10).

[167] Sec. 7701(a)(5) and (9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

[168] Sec. 7874. The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under section 7874 since its enactment in 2004, and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions.

which is an expatriated entity that must recognize certain “inversion gain” post-acquisition restructuring[169] and may be subject to other consequences under the provisions enacted in 2017.[170]

Source of income rules

Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor or recipient and the location of the activities or assets that generate the income. Extensive rules determine whether income is considered to be from U.S. sources or foreign sources.[171] Special rules are provided for certain industries, (*e.g.*, transportation, shipping, and certain space and ocean activities) as well as for income partly from within and partly from without the United States.[172]

Gains, profits, and income from the sale or exchange of inventory property that is either (1) produced (in whole or in part) inside the United States and then sold or exchanged outside the United States or (2) produced (in whole or part) outside the United States and then sold or exchanged inside the United States is allocated and apportioned solely on the basis of the location of the production activities.[173] For example, income derived from the sale of inventory produced entirely in the United States is wholly from U.S. sources, even if title passage occurs elsewhere. Likewise, income derived from the sale of inventory produced entirely in another country is wholly from foreign sources, even if title passage occurs in the United States. If inventory is produced only partly in the United States, the income derived from its sale is sourced partly in the United States regardless of where title to the property passes.

2. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons

In general, income earned directly by a U.S. person from the conduct of a foreign trade or business is taxed currently,[174] while income earned indirectly through certain related foreign

[169] An excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985. In addition, dividends from certain surrogate foreign corporations are excluded from qualified dividend income within the meaning of section 1(h)(11)(B) and are ineligible to be taxed as net capital gains. Sec. 1(h)(11)(C)(iii). As a result, individual shareholders in such corporations cannot claim the reduced rate on dividends otherwise available under section 1(h)(11).

[170] See secs. 59A(d)(4) (providing that payments made to expatriated entities that reduce gross receipts are base erosion payments) and 965(l) (disallowing the partial participation exemption deduction for computing the transition tax and assessing the additional transition tax in the year of inversion if an entity inverts within the 10-year period beginning on December 22, 2017).

[171] Sections 861 through 865, generally.

[172] Sec. 863.

[173] Sec. 863(b). Prior to Public Law 115-97, enacted on December 22, 2017, the source of income from sale of inventory was determined by passage of title.

[174] Such income is called foreign branch income.

entities (*i.e.*, controlled foreign corporations ("CFCs"))[175] is taxed in the year earned or not at all. Earnings and profits of CFCs are generally taxable in one of two ways. First, the earnings may constitute income to U.S. shareholders under the traditional anti-deferral regime of subpart F, which applies to certain passive income and income that is readily movable from one jurisdiction to another.[176] Subpart F was designed as an anti-abuse regime to prevent U.S. taxpayers from shifting passive and mobile income to low-tax jurisdictions.[177] Second, the earnings may be subject to section 951A, which applies to some foreign-source income of a CFC that is not subpart F income (referred to as global intangible low-taxed income ("GILTI")). GILTI was enacted as a base protection measure to counter the participation exemption system, established by the dividends-received-deduction, under which the income could potentially be distributed back to the U.S. corporation with no U.S. tax imposed.[178] Subpart F income is taxed at full rates with related foreign taxes generally eligible for the foreign tax credit; GILTI is taxed at reduced rates with additional limitations on the use of related foreign tax credits. Both subpart F income and GILTI are included by the U.S. shareholder without regard to whether the earnings are distributed by the CFC.

In addition to the taxation of GILTI at reduced rates, U.S. corporations generally are taxed at reduced rates on their foreign-derived intangible income ("FDII").[179] Foreign earnings not subject to tax as subpart F income or GILTI generally are exempt from U.S. tax. To exempt those earnings, dividends received by corporate U.S. shareholders from specified 10-percent owned foreign corporations (including CFCs) generally are eligible for a 100-percent dividends-received deduction ("DRD").[180] Special rules apply in situations in which a U.S. person transfers property to a foreign corporation or certain partnerships in certain nonrecognition transactions.[181]

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[175] A CFC generally is defined as any foreign corporation in which U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only "U.S. shareholders," that is, U.S. persons who own at least 10 percent of the stock (measured by vote or value). See secs. 951(b), 957, and 958. Special rules apply with respect to U.S. persons that are shareholders (regardless of their percentage ownership) in any foreign corporation that is not a CFC but is a passive foreign investment company ("PFIC"). See secs. 1291 through 1298. The PFIC rules generally seek to prevent the deferral of passive income through the use of foreign corporations.

[176] Subpart F comprises sections 951 through 965.

[177] See JCS-5-61, "Tax Effects of Conducting Foreign Business through Foreign Corporations" (July 21, 1961), Part V. See also Rev. Act. of 1962, Pub. L. No. 87-834.

[178] See Reconciliation Recommendations Pursuant to H. Con. Res. 71 (December 2017).

[179] Sec. 250(a)(1)(A).

[180] Sec. 245A. The DRD is not limited to dividends from CFCs, but rather may be available with respect to any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a U.S. shareholder with respect to such foreign corporation.

[181] Secs. 367 and 721(c); Treas. Reg. sec. 1.721(c)-1.

3. U.S. Tax Rules Applicable to Foreign Persons

Nonresident aliens and foreign corporations generally are subject to U.S. tax only on their U.S.-source income. There are two broad types of taxation of U.S.-source income of foreign taxpayers: (1) gross-basis tax on income that is "fixed or determinable annual or periodical gains, profits, and income" (*i.e.*, FDAP income), and (2) net-basis tax on income that is "effectively connected with the conduct of a trade or business within the United States" (*i.e.*, ECI). FDAP income, although nominally subject to a statutory 30-percent gross-basis tax withheld at its source, in many cases is subject to a reduced rate of, or entirely exempt from, U.S. tax under the Code or a bilateral income tax treaty. ECI generally is subject to the same U.S. tax rules and rates that apply to business income earned by U.S. persons.

Finally, certain corporations are subject to a base erosion and anti-abuse tax ("BEAT") that is in the nature of a minimum tax and payable in addition to all other tax liabilities.[182]

Gross-basis taxation of U.S.-source income

FDAP income received by foreign persons from U.S. sources is subject to a 30-percent gross-basis tax (*i.e.*, a tax on gross income without reduction for related expenses), which is collected by withholding at the source of the payment. FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments.[183] The items enumerated in defining FDAP income are illustrative, and the words "annual or periodical" are "merely generally descriptive" of the payments within the purview of the statute.[184] The categories of income subject to the 30-percent tax and the categories for which withholding is required generally are coextensive.[185]

Exclusions from FDAP income

FDAP income encompasses a broad range of gross income but has important exceptions. Capital gains of nonresident aliens generally are foreign source; however, capital gains of nonresident aliens present in the United States for 183 days or more[186] during the year are income from U.S. sources subject to gross-basis taxation.[187] In addition, U.S.-source gains from

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[182] Sec. 59A.

[183] Secs. 871(a) and 881. FDAP income that is ECI is taxed as ECI.

[184] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

[185] See secs. 1441 and 1442.

[186] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

[187] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as ECI under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). See sec. 897(a)(1).

the sale or exchange of intangibles are subject to tax and withholding if they are contingent on the productivity, use, or disposition of the property sold.[188]

Interest on bank deposits may qualify for exemption from treatment as FDAP income on two grounds. First, interest on deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, is U.S.-source income but is exempt from the 30-percent tax when paid to a foreign person.[189] Second, interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not U.S.-source income and, thus, is not subject to U.S. tax.[190] Interest and original issue discount on certain short-term obligations also is exempt from U.S. tax when paid to a foreign person.[191] In addition, an exception to information reporting requirements may apply with respect to payments of such exempt amounts.[192]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[193] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[194] certain contingent interest,[195] interest received by a CFC from a related person,[196] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[197]

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[188] Secs. 871(a)(1)(D) and 881(a)(4).

[189] Secs. 871(i)(2)(A) and 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[190] Sec. 861(a)(1); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[191] Secs. 871(g)(1)(B) and 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[192] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A) and (B). A bank must report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and -8. The IRS publishes lists of the countries whose residents are subject to the reporting requirements, and those countries with respect to which the reported information is automatically exchanged. See Rev. Proc. 2022-35, 2022-40 I.R.B. 270.

[193] Sec. 871(h)(2).

[194] Sec. 871(h)(3). The exemption does not apply to interest payments made to a foreign lender that owns 10 percent or more of the voting power (but not value) of the stock of the borrower.

[195] Sec. 871(h)(4).

[196] Sec. 881(c)(3)(C).

[197] Sec. 881(c)(3)(A).

Withholding of 30-percent gross-basis tax

The 30-percent tax on FDAP income is generally collected by means of withholding.[198] Withholding on FDAP payments to foreign payees is required unless the withholding agent (*i.e.*, the person making the payment to the foreign person) can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[199]

Often, the income subject to withholding is the only income of the foreign person subject to any U.S. tax. If the foreign person has no ECI and the withholding is sufficient to satisfy the tax liability with respect to FDAP income, the foreign person generally is not required to file a U.S. Federal income tax return. Accordingly, the withholding of the 30-percent gross-basis tax generally represents the collection of the foreign person's final U.S. tax liability.

To the extent that a withholding agent withholds an amount, the withheld tax is credited to the foreign recipient of the income.[200] If the agent withholds more than is required, and that results in an overpayment of tax, the foreign recipient may file a claim for refund.

Net-basis taxation of income from conduct of a trade or business within the United States

Income that is effectively connected with the conduct of a trade or business within the United States ("ECI") generally is subject to tax on a net basis under the same U.S. tax rules and rates that apply to business income earned by U.S. persons.[201]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in a U.S. trade or business if the partnership, estate, or trust is so engaged.[202]

Whether a foreign person is engaged in a U.S. trade or business is a factual question that has generated a significant amount of case law. Basic issues include whether the activity rises to the level of a trade or business, whether a trade or business has sufficient connections to the United States, and whether the relationship between the foreign person and persons performing

[198] Secs. 1441 and 1442.

[199] A withholding agent includes any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a). See also Treas. Reg. sec. 1.1441-6 (providing, in part, the requirements (including documentary evidence) that must be satisfied for purposes of claiming the benefits of an exemption from or reduced rate of withholding under a treaty).

[200] Sec. 1462.

[201] Secs. 871(b) and 882.

[202] Sec. 875.

activities in the United States for the foreign person is sufficient to attribute those activities to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[203] Detailed rules govern whether trading in stock or securities, or in commodities, constitutes the conduct of a U.S. trade or business.[204] A foreign person who trades in stock or securities, or in commodities, in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities, or commodities, for the person's own account also generally is not considered to be engaged in a U.S. trade or business so long as the foreign person is not a dealer in stock or securities, or in commodities. This may be the case even in the presence of an office or fixed place of business in the United States through which trades for the person's own account are carried out.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on ECI from that trade or business. Specific statutory rules govern whether income is ECI.[205]

In general, for a foreign person engaged in the conduct of a U.S. trade or business, all income, gain, or loss from sources within the United States is treated as ECI.[206]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business, and whether the activities of the U.S. trade or business were a material factor in the realization of the amount (the "asset use" and "business activities"

[203] Sec. 864(b).

[204] Sec. 864(b)(2) and Treas. Reg. sec. 1.864-2(c) and (d).

[205] Sec. 864(c).

[206] Sec. 864(c)(3).

tests).[207] Under the asset use and business activities tests, due regard is given to whether such asset or such income, gain, deduction, or loss was accounted for through the trade or business.

A foreign person that is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[208] A foreign tax credit may be allowed with respect to foreign income tax imposed on such income.[209] Foreign-source income not included in one of those categories generally is exempt from U.S. tax.

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an independent agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which the agent regularly fills orders on behalf of the foreign person.[210] If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office is a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss is derived.[211]

Certain sales and other dispositions

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[212] If, however, income or gain taken into account for a taxable year is attributable to activity in a prior taxable year (*i.e.*, such as the sale or exchange of property, the performance of services, or any other transaction),

[207] Sec. 864(c)(2).

[208] A foreign person's income from foreign sources generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, goodwill, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange. Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income. Sec. 864(c)(4)(B) and (D)(i).

[209] See sec. 906.

[210] Sec. 864(c)(5)(A).

[211] Sec. 864(c)(5)(B).

[212] Sec. 864(c)(1)(B).

the income or gain is ECI if the income or gain would have been ECI in the prior year.[213] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the income or gain attributable to the disposition of the property is ECI if the income or gain would have been ECI had the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business.[214]

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. Regulations address the allocation and apportionment of deductions between ECI and other income. Certain deductions may be allocated and apportioned on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. Specific rules provide for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. In general, interest is allocated and apportioned based on assets rather than income.

Sales of partnership interests

Gain or loss from the sale or exchange of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.[215] Any gain or loss from such hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

The transferee of a partnership interest must withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the sale qualifies for an exception from withholding, *e.g.*, that the transferor is not a nonresident alien individual or foreign corporation or that there is no realized gain from the sale.[216] If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.[217]

[213] Sec. 864(c)(6).

[214] Sec. 864(c)(7).

[215] Sec. 864(c)(8)(B).

[216] Sec. 1446(f)(1).

[217] Sec. 1446(f)(4); Treas. Reg. sec. 1.1446(f)-2(b).

Foreign Investment in Real Property Act ("FIRPTA")

A foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") is treated as ECI.[218] Thus, a foreign person subject to tax on such a disposition is required to file a U.S. tax return. In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate). Certain sales of USRPI are exempt from this tax. For example, qualified foreign pension funds ("QFPF") are not treated as a nonresident alien individual or foreign corporation subject to tax under FIRPTA,[219] foreign governments are exempt from FIRPTA tax on gain from certain sales of stock of U.S. real property holding corporations,[220] and equity interests in "domestically controlled" REITs are not USRPIs.[221]

The payor of income that FIRPTA treats as ECI is generally required to withhold U.S. tax from the payment.[222] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's overall tax liability for the taxable year.

4. Special measures to address potential tax avoidance

Base erosion and anti-abuse tax

The base erosion and anti-abuse tax (the "BEAT") is an additional tax imposed on certain multinational corporations with respect to payments to foreign affiliates.[223]

The BEAT applies only to corporate taxpayers with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year in excess of $500 million, and is determined, in part, by the extent to which a taxpayer has made payments to foreign related parties.[224] The BEAT generally does not apply to taxpayers for which reductions to taxable income ("base erosion tax benefits") arising from payments to foreign related parties ("base erosion payments") are less than three percent of total deductions (*i.e.*, a "base erosion percentage" of less than three percent).[225]

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[218] Sec. 897(a).

[219] Sec. 897(l)(1).

[220] Treas. Reg. sec. 1.892-3T(a).

[221] Sec. 897(h)(2).

[222] Sec. 1445 and regulations thereunder.

[223] Sec. 59A.

[224] For this purpose, a related party is, with respect to the taxpayer, any 25-percent owner of the taxpayer; any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer; and any other person who is related (within the meaning of section 482) to the taxpayer. Sec. 59A(g). The 25-percent ownership threshold is determined by vote or value.

[225] Sec. 59A.

For a taxpayer subject to the BEAT (an "applicable taxpayer"), the additional tax (the "base erosion minimum tax amount" or "BEAT liability") for the year generally equals the excess, if any, of 10 percent of its modified taxable income over an amount equal to its regular tax liability reduced (but not below zero) by the sum of certain tax credits.[226]

Branch profits taxes

The branch profits tax generally seeks to equalize the tax treatment of a dividend to a foreign person paid from a domestic branch with that paid from a domestic corporation. A domestic corporation is subject to U.S. income tax on its net income. The earnings of the domestic corporation may be subject to a second tax, this time at the shareholder level, when dividends are paid. When the shareholders are foreign, the second-level tax may be collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to withholding tax. To approximate those second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign shareholders, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted (to the head office) out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation.[227] Those branch taxes may be reduced or eliminated under an applicable income tax treaty.[228]

Hybrid arrangements

Hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve tax benefits, including double nontaxation and deferral. Special rules seek to combat the use of such arrangements. These rules include denying deductions relating to certain interest and royalty payments.[229]

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[226] Sec. 59A(e). For taxable years beginning after December 31, 2025, the 10-percent rate on modified taxable income is increased to 12.5 percent, and regular tax liability is reduced (and the base erosion minimum tax amount is therefore increased) by the sum of all the taxpayer's income tax credits for the taxable year. Sec. 59A(b)(2). In addition, special rules with respect to banks and securities dealers provide that for purposes of determining whether they are subject to the BEAT, banks and securities dealers are subject to a base erosion percentage threshold of two percent (rather than three percent), and if that threshold is met, such persons are subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate. Secs. 59A(b)(3) and 59A(e)(1)(C).

[227] Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount." Sec. 884(a). The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI. Sec. 884(b).

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore generally is subject to 30-percent withholding tax if paid to a foreign person. Sec. 884(f)(1)(A). Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, also may be subject to 30-percent withholding tax. Sec. 884(f)(1)(B). For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

[228] See Treas. Reg. secs. 1.884-1(g) and -4(b)(8).

[229] Sec. 267A; see also sec. 245A(e) (addressing hybrid dividends).

Specifically, no deduction is allowed for any "disqualified related party amount"[230] that is paid or accrued pursuant to a hybrid transaction[231] or that is paid or accrued by, or to, a hybrid entity.[232]

5. Resolving Overlapping or Conflicting Jurisdiction to Tax

Multinational enterprises operating in multiple countries may find that the same item of income is subject to tax under the rules of two or more jurisdictions. Such double taxation may be mitigated by domestic laws permitting credit or deduction for income taxes paid to another jurisdiction or by bilateral tax treaties. Another related objective of such treaties is the removal of barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

Relief from double taxation by statute

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed a credit for foreign income taxes they pay. In addition, a domestic corporation is allowed a credit for foreign income taxes paid by a CFC with respect to income included by the corporation as subpart F income and GILTI; such taxes are deemed to have been paid by the domestic corporation for purposes of calculating the foreign tax credit.

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. The limit is intended to ensure that the credit mitigates double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total pre-credit U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may (in certain cases) carry back the excess foreign taxes to the previous year and then carry forward any

[230] A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or in which such related party is subject to tax, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. Sec. 267A(b)(1). A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under subpart F. In general, a related party is any person that controls, or is controlled by, the taxpayer, with control being direct or indirect ownership of more than 50 percent of the vote, value, or beneficial interests of the relevant person. Sec. 267A(b)(2).

[231] A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or in which the recipient is subject to tax. Sec. 267A(c).

[232] A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax but not so treated for Federal income tax purposes. Sec. 267A(d).

remaining excess to one of the 10 succeeding taxable years. No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Bilateral treaties to relieve double taxation

The United States is a partner in numerous bilateral treaties that aim to avoid international double taxation and to prevent tax avoidance and evasion. The United States Model Income Tax Convention of 2016 ("Model Treaty") was published in 2016 and reflects the most recent comprehensive statement of U.S. policy with respect to tax treaties.[233] As explained in the Preamble published contemporaneously with the Model Treaty, the provisions therein included both refinements of provisions that have been included in U.S. tax treaties, as well as new provisions, not yet incorporated in a bilateral treaty, that deny treaty benefits on deductible payments of highly mobile income that are made to related persons that enjoy low or no taxation with respect to that income under a special tax regime.[234] To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions may modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to allocate taxing authority by limiting, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both countries. A "limitation on benefits" provision in treaties further determines whether a treaty resident is a qualified person permitted to receive treaty benefits. This provision limits the ability of third country residents to engage in treaty shopping by establishing conduit legal entities in either the United States or the treaty partner jurisdiction. The provision sets forth objective tests that commonly include a publicly traded company test, an ownership and base erosion test, and an active trade or business test.

[233] The Model Treaty has been updated periodically. The Model Treaty and its Preamble, as well as text of earlier Model Treaties, are available at https://home.treasury.gov/policy-issues/tax-policy/treaties.

[234] For example, the Model Treaty denies treaty benefits when U.S. source payments are made to a beneficial owner that benefits from a special tax regime, as defined in Article 3 (General Definitions), subparagraph (l) of paragraph 1; the benefits that may be denied include the reduced withholding rates on dividends, interest and royalties that are paid to persons that fail to satisfy the limitation on benefits requirements in Article 22 (Limitation on Benefits).

Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction, and the business income is attributable to that permanent establishment. As explained above, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation by requiring a threshold for permanent establishment status that is higher than that required to constitute a U.S. trade or business under the Code. As a result, a foreign corporation engaged in a U.S. trade or business but not through a permanent establishment generally would not be taxable in the United States under an applicable treaty. The term "attributable to" is generally analogous to the "effectively connected" concept in section 864(c). Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount).

Treaties address the taxation of passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely)[235] in return for reciprocal treatment by its treaty partner. In particular, under the Model Treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and some recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

Description of Proposal

Under the proposal, income from U.S. sources earned or received by qualified residents of Taiwan is entitled to certain benefits. These benefits include reduced tax rates for income otherwise subject to the 30-percent gross-basis tax; with respect to income effectively connected with a U.S. trade or business, taxation of only that income effectively connected with a U.S. permanent establishment; and preferential treatment of wages and related income earned by such qualified residents. The new rules are analogous to proposals typical in bilateral treaties to which the United States is a party and are based on relevant language found in the Model Treaty. The proposal requires general anti-abuse standards similar to those in section 894(c) to deny

[235] The rates agreed upon in U.S. bilateral tax treaties for income other than personal services income are found in "Table 1. Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties (Rev. May 2023)" at https://www.irs.gov/individuals/international-taxpayers/tax-treaty-tables.

benefits when payments are made through hybrid entities. The proposed rules are applicable only if reciprocal provisions apply to U.S. persons with respect to income sourced in Taiwan.

Treatment of certain income from U.S. sources

Special rules address the treatment of several forms of income received by qualified residents of Taiwan from U.S. sources are described below. Interest, royalties, certain gains and dividends that would otherwise be subject to a 30-percent gross-basis tax (*i.e.*, a tax on gross income without reduction for related expenses) withheld at the source are eligible for reduced rates. Other types of income received by individuals that are subject to net-basis tax are also eligible for relief under proposals that address qualified wages and income of athletes and entertainers.

Interest, royalties and gains

Tax on U.S.-source interest (other than original issue discount), royalties, amounts described in section 871(a)(1)(C), and gains described in section 871(a)(1)(D) that are paid to or received by a qualified resident of Taiwan is reduced to 10 percent. The treatment of these types of income is consistent with that provided under Model Treaty Articles 11 (Interest), 12 (Royalties), and 13 (Gains).

Dividends

Tax on U.S.-source dividends that are paid to or received by a qualified resident of Taiwan is reduced to 15 percent. The reduction in rates follows the treaty benefits provided under Model Treaty Article 10 (Dividends).

The reduced rates do not apply to amounts subject to FIRPTA; payments between an expatriated entity and a related party; any amount which is included in income under section 860C to the extent that such amount does not exceed an excess inclusion with respect to a REMIC; and dividends paid by a REIT other than qualified REIT dividends. A dividend paid by a REIT is a qualified REIT dividend if the dividend is paid with respect to a class of shares that is publicly traded and the owner of the dividend holds not more than five percent of any class of shares in the REIT.

Certain qualified residents of Taiwan that are taxable as corporations in Taiwan may be eligible for a further reduction in the tax rate (*i.e.*, from 15 percent to 10 percent) with respect to dividends, provided that certain holding period and ownership thresholds are met. To qualify for the 10-percent tax rate on dividends, at all times during the 12-month period ending on the date on which the stock in a corporation becomes ex-dividend with respect to such dividend, the dividend recipient must be a qualified resident of Taiwan and directly own at least 10 percent of the vote and value of the total outstanding shares of stock in such corporation. For purposes of the 12-month period, a dividend recipient shall be permitted to tack the holding period of an entity taxed as a corporation in Taiwan from whom the dividend recipient acquired such stock, if that entity was a qualified resident of Taiwan and a "connected person" with respect to the dividend recipient at the time the share was acquired. Persons are "connected persons" if one person owns, directly or indirectly, at least 50 percent of the beneficial interest in the other (or, if a corporation, at least 50 percent of the vote and value of its shares); a third person owns, directly

or indirectly, at least 50 percent of the beneficial interest in each person (or, if a corporation, at least 50 percent of the vote and value of its shares). In addition, a person may be a connected person if, based on all the relevant facts and circumstances, one has control of the other, or both are under the control of the same persons. In no event is a dividend paid by a RIC or a REIT eligible for this further reduction in tax rate.

Income from employment

Qualified wages for personal services performed within the United States generally are not subject to U.S. income tax if paid by an employer to a qualified resident of Taiwan who is either not a U.S. resident or is employed as a member of the regular component of a ship or aircraft operated in international traffic. The definition of qualified wages follows the definition in Model Treaty Article 14 (Income from Employment) to include amounts paid by or on behalf of a non-U.S. person (and not borne by a U.S. permanent establishment) in the form of wages, salaries, or similar remunerations with respect to personal services performed in the United States. Directors' fees, income derived as a student or trainee, pensions, or amounts paid with respect to employment with the United States, any State, or any U.S. possession, or other amounts specified in regulations or guidance are not included within the scope of qualified wages.

Income from services as an entertainer or athlete

Income derived by a qualified resident of Taiwan for services performed as an entertainer or athlete in the United States generally is subject to income tax in the United States but may avoid U.S. taxation if gross receipts from such services do not exceed in total (including amounts received as reimbursement of expenses) $30,000. If total receipts from the performance of services as an entertainer or athlete exceeds $30,000, then the entire amount is subject to taxation in the United States. Income from such services accruing to a person other than the entertainer or athlete performing such services also may qualify for the exemption from U.S. taxation, but only if the person receiving the income is contractually authorized to designate another person or persons to provide the services.

This proposal is intended to be consistent with the rules in Model Treaty Article 16 (Entertainers and Sportsmen), which generally provides that income derived from services performed by entertainers and athletes resident in one treaty partner jurisdiction may be subject to tax based on the source of income rather than the residence of the performer or athlete, notwithstanding the provisions of Model Treaty Article 14 (Income from Employment).

Income effectively connected with a U.S. permanent establishment

Income of a qualified resident of Taiwan that is effectively connected with a U.S. permanent establishment is subject to tax on a net basis (under section 1 for noncorporate persons and section 11 for corporations). In addition, such ECI continues to be subject to the alternative minimum tax and BEAT, if applicable. In determining taxable income for these purposes, gross income includes only gross income which is effectively connected with the permanent establishment.

Various rules of special application are provided for determining whether rules regarding ECI are modified. First, under FIRPTA, to ensure that the ultimate substantive tax treatment of FIRPTA income is unchanged, references to "trade or business within the United States" are changed to refer to carrying on a trade or business through a U.S. permanent establishment. The branch profits tax applicable to ECI (including the branch profits tax on interest) is reduced to 10 percent, thus matching the reduced rate for dividends and interest that would otherwise apply. The proposal adopts the anti-abuse standards of section 894(c) to deny benefits when payments are made through hybrid entities.

In addition, wages, salaries, or similar remunerations with respect to employment as well as directors' fees, income from services as an entertainer or athlete, income derived as a student or trainee, pensions, and amounts paid with respect to employment with the United States are outside the scope of income considered to be effectively connected with a permanent establishment. This limitation is in accordance with language in Model Treaty Article 7 (Business Profits), paragraph 4, which provides that "[w]here profits include items of income that are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

Definition of U.S. permanent establishment

A U.S. permanent establishment is a fixed place of business through which a qualified resident of Taiwan conducts an active trade or business within the United States. A U.S. permanent establishment need not be subject to corporate tax in Taiwan to qualify. The fixed place may include a place from which a trade or business is managed, as well as an office, factory, workshop, branch, site in which minerals are extracted, or other sites. Such a fixed place generally does not include sites maintained for a limited purpose such as storage, display, or auxiliary or preparatory work; further, such a fixed place generally does not include a fixed place of business of an independent agent even if such agent habitually contracts on behalf of the foreign entity. Following Model Treaty Article 5 (Permanent Establishment), special rules on the extent to which a temporary project may constitute a fixed place of business are provided.

Qualified resident of Taiwan

Following Model Treaty Article 4 (Resident), the proposal defines residence for both individuals and entities. In general, a "qualified resident of Taiwan" is entitled to the benefits of the new proposal. The term generally includes any person that is not a U.S. person who is liable for tax in Taiwan and establishes domicile, residence, management or control, or place of incorporation in Taiwan. Rules specific to individuals, as well as specific limitations on eligibility of corporations, are provided.

Individuals

In general, the Code provides that the residence of an individual other than a U.S. citizen be determined by application of section 7701(b). If such a person also has met the foregoing criteria for status as a qualified resident of Taiwan, such individual may be a dual resident, whose residence must be resolved after further inquiry.

Resolving residence of a dual resident

The residence of a dual resident is resolved by applying a hierarchy of three tests based on the individual's permanent home, center of vital interests, or habitual abode. The first inquiry is where the individual has a permanent home. If the individual has a permanent home in Taiwan but not the United States, the permanent home is determinative of residence. If a person has permanent homes in both jurisdictions, the second inquiry is whether the individual has a center of vital interests in Taiwan. If the person has a permanent home in both jurisdictions and the center of vital interests cannot be determined, or has no permanent home in either jurisdiction, then the individual's residence is based on the individual's habitual abode. If an individual's residence cannot be determined by habitual abode, that person is not a qualified resident of Taiwan for purposes of claiming benefits under this proposal.

Rules for determining residence of an entity

Entities taxed as corporations in Taiwan are treated as qualified residents of Taiwan if they meet an ownership and income test, a publicly traded in Taiwan test, or a qualified subsidiary test. In addition, qualified items of income are treated as income of a qualified resident of Taiwan.

Ownership and income thresholds for non-publicly traded entities

The ownership and income tests require that at least 50 percent by vote and value of the entity is owned (directly or indirectly) by qualified residents of Taiwan and that less than 50 percent of gross income of the entity (and, in the case of an entity that is a member of a tested group, less than 50 percent of the tested group's gross income) is in the form of payments deductible for purposes of income taxes imposed by Taiwan to persons who are neither qualified residents of Taiwan nor certain U.S. persons whose connection to the United States meets comparable tests, as determined by the Secretary. Indirect ownership for purposes of the ownership threshold requires that all intermediate owners are qualifying intermediate owners; that is, a qualified resident of Taiwan or resident of a foreign country with which the United States has a comprehensive tax treaty for the relief of double taxation, provided that the foreign country is not a country of concern within the meaning of that term as included in the CHIPS Act of 2022.[236]

Certain deductible payments are not included in gross income for purposes of the income test. Such deductible payments do not include arm's-length payments by an entity in the ordinary course of an active trade or business for services or tangible property and do not include certain intragroup transactions within a tested group. A tested group is defined as a group of two or more corporations that participate in a group for tax consolidation, fiscal unity or other plan that requires the corporations to share profits and losses, or that share losses through group relief or other loss sharing regimes.

[236] Section 103(a)(4) of the CHIPS Act of 2022.

Publicly traded test

Alternatively, an entity may establish itself as a qualified resident of Taiwan under the publicly traded test. An entity is considered to be publicly traded in Taiwan if its principal class of shares (and any disproportionate class of shares) is primarily and regularly traded on an established securities market in Taiwan. If such shares of an entity are not primarily traded in Taiwan but the entity has its primary place of management and control in Taiwan and its principal class of shares (and any disproportionate class of shares) is regularly traded there on an established securities market, the entity meets the publicly traded test.

Qualified subsidiary test

An entity that does not meet the above ownership and income test or publicly traded test may nonetheless be eligible for the benefits described herein if that entity meets the qualified subsidiary test. Entities that meet the income requirements of the ownership and income tests may qualify if they are owned at least 50 percent by five or fewer corporations that themselves satisfy the publicly traded test or are U.S. persons, the shares of which are primarily and regularly traded in the United States on an established securities market. For this purpose, the indirect ownership of the qualified subsidiary is met only if all intermediate owners are themselves qualifying intermediate owners, which, for purposes of the qualified subsidiary test only, may include U.S. persons that satisfy tests comparable to the test for a qualified resident of Taiwan, as determined by the Secretary. In addition, qualifying intermediate owners also include a qualified resident of Taiwan or a resident of a foreign country with which the United States has a comprehensive tax treaty for the relief of double taxation and is not a country of concern.

Active trade or business test

Even if an entity is not otherwise a qualified resident of Taiwan, a qualified item of income from the United States that is derived by a person subject to income tax under Taiwan law (and that is not a U.S. person) shall be treated as income of a qualified resident of Taiwan. A qualified item of income includes any item of income which emanates from, or is incidental to, the conduct of an active trade or business in Taiwan and, if such person derives an item of income from a trade or business activity conducted in the United States, or derives an item of income arising in the United States from a connected person, the trade or business activity in Taiwan to which the item relates is required to be substantial in relation to the same or complementary trade or business activity in the United States. The trade or business activity in the United States may be carried on by such person or any connected person. The active trade or business test is not available for any item of income derived by an entity if at least 50 percent (by vote or value) of such entity is owned (directly or indirectly) or controlled by residents of a foreign country of concern.

Reciprocity requirements

Before any of the foregoing rules are applicable in any taxable period, the Secretary must determine that certain reciprocity requirements are met, ensuring that U.S. persons subject to income tax in Taiwan are afforded reciprocal benefits. Reciprocity may be determined in any appropriate manner.

Regulations

The proposal grants the Secretary authority to promulgate regulations on a variety of enumerated issues. These issues include regulations or guidance for determining what constitutes a U.S. permanent establishment of a qualified resident of Taiwan and income that is effectively connected to such a permanent establishment; preventing the abuse of the proposals of this section by persons who are not (or who should not be treated as) qualified residents of Taiwan; requirements for record keeping and reporting; rules to assist withholding agents or employers in determining whether a foreign person is a qualified resident of Taiwan or whether reporting is required for a payment; the application of the proposal to ownership thresholds attributable to stock held by predecessor owners; determining what amounts are to be treated as qualified wages; defining established securities markets for the limitation on benefits proposals; the application of the legislation to qualified residents of Taiwan that are partners of a partnership or beneficiaries of an estate or trust; determining ownership interests held by residents of foreign countries of concern; determining what items are to be treated as qualified items of income under the active trade or business proposals of the limitation of benefits to prevent abuse of the purposes of this section; and determining the starting and ending dates for periods with respect to the reciprocity requirements. To the extent practical, the regulations shall be consistent with the relevant Model Treaty provisions.

Effective Date

The proposals of Title A are effective on date of enactment, subject to satisfaction of the contingent reciprocity standards being met.

B. The United States-Taiwan Tax Agreement Authorization Act

Present Law

The applicable present law is described above under section A of this Part.

Description of Proposal

The United States-Taiwan Tax Agreement Authorization Act authorizes the President to negotiate and enter into one or more non-self-executing tax agreements (in each case, the "Agreement") to provide for bilateral tax relief with Taiwan beyond that provided for in section 894A (as added by United States-Taiwan Expedited Double-Tax Relief Act) and prescribes the process for approving and implementing such an agreement, as described below.[237]

Authorization to negotiate and enter into Agreement

After a determination by the Secretary of the Treasury that Taiwan has provided benefits to U.S. persons that are reciprocal to the benefits provided to qualified residents of Taiwan under section 894A, the President is authorized to negotiate and enter into the Agreement. Any provisions in the Agreement must conform with provisions customarily contained in U.S. bilateral income tax conventions, as exemplified by the 2016 U.S. Model Income Tax Convention, and the Agreement may not include elements outside the scope of the 2016 U.S. Model Income Tax Convention.

Notwithstanding such conformity, the Agreement may incorporate and restate provisions of any agreement, as well as existing U.S. law, addressing double taxation for residents of the United States and Taiwan. The Agreement shall include the following statement: "The Agreement is entered into pursuant to the United States-Taiwan Tax Agreement Authorization Act." The Agreement is required to include a provision conditioning entry into force upon enactment of approval legislation and implementing legislation (as described below) and confirmation by the Secretary of the Treasury that the relevant authority in Taiwan has approved and taken appropriate steps required to implement the Agreement.

Consultations with Congress

The proposal requires the President to provide written notification to certain appropriate congressional committees of the commencement of negotiations with Taiwan at least 15 calendar days prior to commencing negotiations. In addition, no later than 90 days after commencing negotiations and every 180 days thereafter until the President enters into the Agreement, the President is required to provide a briefing to the appropriate congressional committees on the status of the negotiations, including a description of elements under negotiation.

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[237] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 5988."* (JCX-draft-23), November __, 2023. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references in the document are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise stated.

The appropriate congressional committees include the Committee on Foreign Relations and the Committee on Finance of the Senate, as well as the Committee on Ways and Means of the House of Representatives.

During the course of negotiations with respect to the Agreement, the Secretary of the Treasury, in coordination with the Secretary of State, upon request, is required to meet with the chairman or ranking member of any of the appropriate congressional committees regarding negotiating objectives and the status of negotiations in progress. In addition, the Secretaries must closely and timely consult with the appropriate congressional committees, as well as keep such committees fully apprised of the negotiations. Such consultations are required to include the nature of the contemplated Agreement, how and to what extent the contemplated Agreement is consistent with the scope of the 2016 U.S. Model Income Tax Convention, and the implementation of the contemplated Agreement, including (i) the general effect of the contemplated Agreement on existing laws, (ii) proposed changes to any existing laws to implement the contemplated Agreement, and (iii) proposed administrative actions to implement the contemplated Agreement.

Approval and implementation of Agreement

The Agreement may not enter into force unless:

- the President publishes the text of the contemplated Agreement on a publicly available website of the Department of the Treasury at least 60 days before the day on which the President enters into the Agreement, and

- there is enacted into law, with respect to the Agreement, approval legislation and implementing legislation.

The President may provide for the Agreement to enter into force upon enactment of approval legislation and implementing legislation and confirmation by the Secretary of the Treasury that the relevant authority in Taiwan has approved and taken appropriate steps required to implement the Agreement. Approval legislation means legislation that approves the Agreement and implementing legislation means legislation that makes any changes to the Code necessary to implement the Agreement.

Submission of Agreement

The proposal requires that no later than 270 days after the President enters into the Agreement, the President or the President's designee shall submit to Congress the final text of the Agreement and a technical explanation of the Agreement. In addition, no later than 270 days after the President enters into the Agreement, the Secretary of the Treasury shall submit to Congress a description of those changes to existing laws that the President considers would be required in order to ensure that the United States acts in a manner consistent with the Agreement, and a statement of anticipated administrative action proposed to implement the Agreement.

Consideration of approval legislation and implementing legislation

The proposal requires that the approval legislation relating to the Agreement include the following text, "Congress approves the Agreement submitted to Congress pursuant to section 206 of the United States-Taiwan Tax Agreement Authorization Act on ____" with the blank space being filled with the appropriate date. The approval legislation is required to be referred to the Committee on Foreign Relations in the Senate and to the Committee on Ways and Means in the House of Representatives.

The implementing legislation is required to be referred to the Committee on Finance in the Senate and the Committee on Ways and Means in the House of Representatives.

Relationship of Agreement to Internal Revenue Code of 1986

The proposal states that the provisions of the Agreement or approval legislation, or the application of any such provision, that are inconsistent with the Code do not have effect. Nothing in the proposal is intended to be construed to amend or modify any law of the United States or to limit any authority conferred under any law of the United States, unless specifically provided for in the proposal.

Authorization of subsequent tax agreements relative to Taiwan

After enactment of approval legislation and implementing legislation, the tax agreement that is authorized by this proposal is required to be treated as including any tax agreement relative to Taiwan which supplements or supersedes the Agreement to which such approval legislation and implementing legislation relates. The term "Agreement" shall be treated as including such tax agreement. The proposal is required to be applied separately with respect to each such tax agreement.

Congressional findings and statement of policy

The proposal makes the following findings: the United States addresses issues with respect to double taxation with foreign countries by entering into bilateral income tax conventions (known as tax treaties) with such countries negotiated by the President pursuant to Article II of the Constitution, and subject to the advice and consent of the Senate; the United States has entered into more than sixty such tax treaties, which facilitate economic activity, strengthen bilateral cooperation, and benefit U.S. workers, businesses, and other U.S. taxpayers; and because of Taiwan's unique status, the United States is unable to enter into an Article II tax treaty with Taiwan, necessitating an alternative means to address issues with respect to double taxation.

The proposal states that it is the policy of the United States to provide for additional bilateral tax relief with respect to Taiwan, beyond that provided for in section 894A (as added by the United States-Taiwan Expedited Double-Tax Relief Act), only after entry into force of an Agreement and only in a manner consistent with such Agreement. It further states that it is the policy of the United States to continue to provide for relief from double taxation and other related matters through entering into bilateral income tax conventions, negotiated by the

President pursuant to Article II of the Constitution, and subject to the advice and consent of the Senate.

Effective Date

Title B is effective upon date of enactment.

IV. ASSISTANCE FOR DISASTER-IMPACTED COMMUNITIES

Present Law

Exclusion from income for qualified disaster relief payments

Present law provides an exclusion from income for qualified disaster relief payments.[238] Qualified disaster relief payments include amounts paid to an individual: (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster; (2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster; (3) by a person engaged in the furnishing or sale of transportation (*i.e.,* common carriers) by reason of death or personal injuries as a result of a qualified disaster; or (4) by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare.[239] These amounts do not include payments for any expenses compensated for by insurance or otherwise.[240]

Qualified disaster relief payments also are excludable for purposes of self-employment taxes and employment taxes.[241]

A qualified disaster is a disaster which results from a terroristic or military action (as defined in section 692(c)(2)); a Federally declared disaster (as defined in section 165(i)(5)(A)); a disaster which results from an accident involving a common carrier or from any other event which would be determined by the Secretary of the Treasury (the "Secretary") to be of a catastrophic nature; or, for purposes of payments made by a Federal, State or local government, or an agency or instrumentality of a government, a disaster designated by an applicable Federal, State, or local authority (as determined by the Secretary) to warrant assistance.[242]

The exclusion from income does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack, or to a representative of such individual.[243] No deduction or credit is allowed for, or by reason of, any expenditure to the extent of the amount excluded from income with respect to such expenditure.[244]

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[238] Sec. 139.

[239] Sec. 139(b).

[240] *Ibid.*

[241] Sec. 139(d).

[242] Sec. 139(c).

[243] Sec. 139(e).

[244] Sec. 139(h).

Personal casualty losses

In general

An individual taxpayer may claim an itemized deduction for a personal casualty loss.[245] If the loss is attributable to a disaster declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, (the "Stafford Act")[246] then the loss is deductible only to the extent of the sum of the individual's personal casualty gains plus the amount by which aggregate net disaster-related losses exceed 10 percent of the individual taxpayer's adjusted gross income.[247] In any taxable year beginning after December 31, 2017, and before January 1, 2026, all other personal casualty losses are deductible only to the extent that the losses do not exceed the individual's personal casualty gains.

For individual taxpayers, personal casualty losses are losses of property not connected with a trade or business or a transaction entered into for profit that arise from fire, storm, shipwreck, or other casualty, or from theft.[248] Personal casualty gains are recognized gains from any involuntary conversion of property not connected with a trade or business or a transaction entered into for profit that arise from fire, storm, shipwreck, or other casualty, or from theft.[249] Personal casualty losses are deductible to the extent they exceed $100 per casualty.[250]

Additional relief for certain disasters

Congress has at times enacted taxpayer favorable casualty loss provisions in response to specific natural disasters.[251]

Most recently, Division EE of Public Law 116-260, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (the "2020 Disaster Act"), provides special rules for "qualified disaster-related personal casualty losses," personal casualty losses arising in a qualified disaster area on or after the first day of the incident period of the applicable qualified disaster which are attributable to that qualified disaster.[252] These losses are deductible without regard to whether

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[245] Sec. 165(h).

[246] Sec. 165(h)(5) and Pub. L. No. 100-707.

[247] Sec. 165(h)(2). Personal casualty gains are reduced for this purpose by any gain used to offset any personal casualty loss which is not attributable to a disaster.

[248] Sec. 165(c)(3)(B).

[249] Sec. 165(c)(3)(A).

[250] Sec. 165(h)(1).

[251] See, *e.g.*, sec. 204(b) of Pub. L. No. 116-94 (Hurricanes Florence and Michael); sec. 20104(b) of Pub. L. No. 115-123 (certain California wildfires); sec. 504(b) of Pub. L. No. 115-63 (Hurricanes Harvey, Irma, and Maria); and former sec. 1400S(b) (Hurricanes Katrina, Rita, and Wilma).

[252] Sec. 304(b) of Div. EE. of Pub. L. No. 116-260.

aggregate net losses exceed 10 percent of a taxpayer's adjusted gross income. These losses are deductible to the extent they exceed $500 per casualty. These losses are allowed as a deduction in addition to the standard deduction and are allowed against alternative minimum taxable income.

A "qualified disaster area" refers to an area with respect to which a major disaster has been declared by the President during the period beginning on January 1, 2020, and ending on the date which is 60 days after the date of enactment of the 2020 Disaster Act,[253] under section 401 of the Stafford Act, if the incident period of the disaster with respect to which the declaration is made begins on or after December 28, 2019 and on or before the date of enactment of the 2020 Disaster Act. A qualified disaster area does not include any area with respect to which a major disaster had been declared only by reason of COVID-19.[254]

A "qualified disaster" is, with respect to the applicable qualified disaster area, the disaster by reason of which a major disaster was declared with respect to that area.[255]

The "incident period" is, with respect to the applicable qualified disaster, the period specified by the Federal Emergency Management Agency as the period during which the disaster occurred, except that the period is not treated as ending after the date which is 30 days after the date of enactment of the 2020 Disaster Act.[256]

Description of Proposals

Certain disaster-related personal casualty losses

For purposes of personal casualty losses arising in a qualified disaster area, the proposal broadens the 2020 Disaster Act's definition of qualified disaster area to include any area with respect to which a major disaster was declared by the President during the period beginning on January 1, 2020, and ending on the date which is 60 days after the date of enactment of the proposal, under section 401 of Stafford Act if the incident period of the disaster begins on or after December 28, 2019, and on or before the date of enactment of the proposal. The incident period will be treated as ending no later than the date which is 30 days after the date of enactment of the proposal.

Thus, under the proposal, certain disaster-related personal casualty losses attributable to major disasters beginning any time after the date of enactment of the 2020 Disaster Act and through the date of enactment of the proposal are provided the same treatment as qualified disaster-related personal casualty losses under the 2020 Disaster Act.

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[253] The 2020 Disaster Act became law on December 27, 2020.

[254] Sec. 301 of Div. EE. of Pub. L. No, 116-260.

[255] *Ibid.*

[256] *Ibid.*

Exclusion of certain wildfire relief payments

The proposal provides an exclusion from gross income for amounts received as qualified wildfire relief payments. Qualified wildfire relief payments are amounts received by or on behalf of an individual as compensation for losses, expenses, or damages (including compensation for additional living expenses, lost wages (other than compensation for lost wages paid by the employer which would have otherwise paid such wages), personal injury, death, or emotional distress) incurred as a result of a qualified wildfire disaster, but only to the extent the losses, expenses, or damages compensated by such payment are not compensated for by insurance or otherwise.

A qualified wildfire disaster is any Federally declared disaster (as defined in section 165(i)(5)(A)) declared, after December 31, 2014, as a result of any forest or range fire.

No deduction or credit is allowed with respect to any expenditure to the extent of the amount excluded under the proposal with respect to the expenditure. The basis of any property is not increased by amounts excluded from gross income under the proposal.

East Palestine disaster relief payments

The proposal treats East Palestine train derailment payments as qualified disaster relief payments for purposes of section 139(b). As a consequence, the payments are excluded from gross income and are subject to other present-law provisions, such as the employment tax exclusions from wages and net earnings from self-employment (section 139(d)) and the prohibition on double benefits (section 139(h)), applicable to qualified disaster relief payments.

The proposal defines East Palestine train derailment payment as any amount received by or on behalf of an individual as compensation for loss, damages, expenses, loss in real property value, closing costs with respect to real property (including realtor commissions), or inconvenience (including access to real property) resulting from the East Palestine train derailment if the amount was provided by a Federal, State, or local government agency, Norfolk Southern Railway, or a subsidiary, insurer, or agent of Norfolk Southern Railway or any related person. For this purpose, East Palestine train derailment means the derailment of a train in East Palestine, Ohio on February 3, 2023.

Effective Dates

The proposal relating to certain disaster-related personal casualty losses is effective on date of enactment.

The proposal relating to the exclusion of certain wildfire relief payments applies to qualified wildfire relief payments received during taxable years beginning after December 31, 2019, and before January 1, 2026.

The proposal relating to the East Palestine train derailment applies to amounts received on or after February 3, 2023.

V. MORE AFFORDABLE HOUSING

1. State housing credit ceiling increase for low-income housing credit

Present Law

A taxpayer may claim the low-income housing credit annually over a 10-year period for the costs of building or rehabilitating rental housing occupied by low-income tenants. The amount of credit that may be claimed each year is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.[257]

Generally, the low-income housing credit is allowable only if the taxpayer receives a credit allocation from a State or local housing credit agency. For calendar year 2024, after application of a cost-of-living adjustment, the aggregate credit authority provided annually to each State (the "State housing credit ceiling") is $2.90 multiplied by the State population, with a minimum annual credit amount of $3,360,000 for certain small population States.[258] For calendar years 2018, 2019, 2020, and 2021, the State housing credit ceiling was increased by multiplying the State housing credit ceiling dollar amount by 1.125.[259]

Description of Proposal

The proposal provides an increase in the State housing credit ceiling for calendar years 2023, 2024, and 2025. In each of those calendar years, the dollar amount in effect for determining the current-year credit ceiling (after any increase due to the applicable cost-of-living adjustment) is increased by multiplying the dollar amount for that year by 1.125.

Effective Date

The proposal applies to calendar years after 2022.

2. Tax-exempt bond financing requirement

Present Law

A taxpayer may claim the low-income housing credit annually over a 10-year period for the costs of building or rehabilitating rental housing occupied by low-income tenants. The amount of credit that may be claimed each year is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.[260]

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[257] Sec. 42(a).

[258] Rev. Proc. 2023-34, 2023-48 I.R.B. 1287, November 9, 2023. For calendar year 2023, the small population States were Alaska, Delaware, the District of Columbia, Montana, North Dakota, Rhode Island, South Dakota, Vermont, and Wyoming. See Notice 2023-22, 2023-12 I.R.B. 569, March 17, 2023.

[259] Sec. 42(h)(3)(I).

[260] Sec. 42(a).

Credit calculations

The applicable percentage for non-Federally subsidized newly constructed housing and non-Federally subsidized substantial rehabilitation is calculated such that the present value of the 10 annual credit amounts equals 70 percent of a building's qualified basis.[261] The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual applicable Federal rate ("AFR") for mid-term and long-term obligations for the month the building is placed in service. However, under the Housing and Economic Recovery Act of 2008,[262] the minimum applicable percentage for such credits was temporarily set at nine percent. The Consolidated Appropriations Act, 2016[263] made the nine-percent minimum applicable rate permanent. These credits are sometimes referred to as "nine-percent credits."

The applicable percentage for Federally subsidized newly constructed housing, Federally subsidized substantial rehabilitation, and certain housing acquisition costs is calculated such that the present value of the 10 annual credit amounts equals 30 percent of a building's qualified basis. The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual AFR for mid-term and long-term obligations for the month the building is placed in service. However, under the Consolidated Appropriations Act, 2021,[264] the minimum applicable percentage for such credits was permanently set at four percent. These credits are sometimes referred to as "four-percent credits."

Rehabilitation expenditures

Certain rehabilitation expenditures paid or incurred by the taxpayer are treated for purposes of the low-income housing credit as a separate new building. Rehabilitation expenditures are amounts chargeable to the capital account and incurred for depreciable property (or additions or improvements to depreciable property) in connection with the rehabilitation of a building. However, rehabilitation expenditures do not include, for example, the cost of acquiring an existing building.[265]

Generally, the rule treating rehabilitation expenditures as a separate new building applies only if, as of the close of the first tax year in the credit period, two conditions are met with respect to such expenditures. First, the expenditures must be allocable to one or more low-income units or substantially benefit such units. Second, the amount of the expenditures during any 24-month period must meet one of the following requirements (whichever requires the greater amount of expenditures): (1) the amount must be at least 20 percent of the adjusted basis

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[261] See sec. 42(b)(1)(B) and (e).

[262] Pub. L. No. 110-289, July 30, 2008.

[263] Pub. L. No. 114-113, December 18, 2015.

[264] Pub. L. No. 116-260, December 27, 2020.

[265] Sec. 42(e)(1) and (2).

of the building (determined as of the first day of the 24-month period),[266] or (2) the qualified basis attributable to the expenditures, when divided by the number of low-income units in the building, must be at least $6,000 (subject to an inflation adjustment).[267]

For purposes of treating rehabilitation expenditures as a separate building, such expenditures are treated as placed in service at the close of the 24-month period described above.[268]

Tax-exempt bond-financed buildings

Generally, the low-income housing credit is allowable only if the taxpayer receives a credit allocation from a State or local housing credit agency. However, a building may be allowed four-percent credits without receiving a credit allocation if at least 50 percent of the aggregate basis of the building and the land on which the building is located is financed with tax-exempt obligations that are subject to the State private activity bond volume limit ("tax-exempt bonds"). If less than 50 percent of the aggregate basis of the building and the land on which the building is located is financed with tax-exempt bonds, only the portion of credits attributable to the bond-financed portion of the building is allowed without a credit allocation.[269]

Description of Proposal

The proposal temporarily lowers the 50-percent bond-financing threshold for purposes of the exception to the credit allocation requirement under certain conditions. Under the proposal, a building may be allowed four-percent credits without receiving a credit allocation if two requirements are met. First, at least 30 percent of the aggregate basis of the building and the land on which the building is located must be financed with one or more qualified obligations. A qualified obligation is a tax-exempt bond that is part of an issue the issue date of which is before January 1, 2026. Second, at least five percent of the aggregate basis of the building and the land on which the building is located must be financed with one or more qualified obligations that are part of an issue the issue date of which is after December 31, 2023. Therefore, for purposes of satisfying the second condition, the obligations must be part of an issue the issue date of which is after December 31, 2023, and before January 1, 2026.

Effective Date

The proposal applies to buildings placed in service in taxable years beginning after December 31, 2023. For this purpose, in the case of any building with respect to which any expenditures are treated as a separate new building under section 42(e), both the existing

[266] Without regard to sec. 1016(a)(2) and (3).

[267] Sec. 42(e)(3).

[268] Sec. 42(e)(4).

[269] Sec 42(h)(4).

building and the separate new building are treated as having been placed in service on the date the expenditures are treated as placed in service under section 42(e)(4).

VI. TAX ADMINISTRATION AND ELIMINATING FRAUD

1. Increase in threshold for requiring information reporting with respect to certain payees

Present Law

Information reporting requirements

Present law requires persons to file an information return concerning certain transactions with other persons.[270] The person filing an information return (the "payor") is also required to provide the person for whom the information return is being filed (the "payee") with a written statement showing the information that was reported to the Internal Revenue Service ("IRS"), which generally includes aggregate payments made, and the contact information for the payor.[271] These returns are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such income tax returns are correct and complete.

For example, every person engaged in a trade or business who makes certain payments aggregating $600 or more in any taxable year to a single payee in the course of such trade or business must report those payments to the IRS.[272] This requirement applies to fixed or determinable payments of income as well as nonemployee compensation, generally reported on either Form 1099-MISC, *Miscellaneous Information*, or Form 1099-NEC, *Nonemployee Compensation*. In addition, any service recipient engaged in a trade or business and paying for services is required to make a return according to regulations when aggregate payments equal $600 or more.[273] Governmental entities are specifically required to make an information return,[274] and in the case of payments by Federal executive agencies that extends to reporting payments to corporations as well as individuals.[275]

However, these provisions discussed above do not cover payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements, such as provisions covering dividends, interest, and royalties.[276] Treasury regulations generally provide

[270] Secs. 6041 through 6050Y.

[271] See, *e.g.*, sec. 6041(d).

[272] Sec. 6041.

[273] Sec. 6041A.

[274] Sec. 6041(A)(d)(2).

[275] Sec. 6041A(d)(3)(A).

[276] Section 6041(a) generally excepts from its scope most interest, royalties, and dividends, which are instead covered by sections 6049, 6050N, and 6042, respectively.

further exceptions from the reporting of payments to corporations, exempt organizations, governmental entities, international organizations, and retirement plans.[277]

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of $250 for each return with respect to which such a failure occurs, up to a maximum of $3,000,000 in any calendar year, adjusted for inflation.[278] Similar penalties apply to failures to furnish correct written statements to recipients of payments for which information reporting is required.[279] The failure to file and failure to furnish penalties are reduced for small businesses[280] and increased for failures due to intentional disregard.[281]

Backup withholding

Generally, a payor is not required to withhold taxes from payments to the payee. However, a payor may be required to deduct and withhold income tax on certain "reportable payments" at a rate equal to 24 percent[282] if: (1) the payee fails to furnish his or her taxpayer identification number ("TIN") to the payor; (2) the IRS notifies the payor that the payee's TIN is incorrect; (3) a notified payee underreporting of reportable payments has occurred; or (4) a payee certification failure with respect to reportable payments has occurred.[283] The requirement to deduct and withhold in the case of a notified payee underreporting or a payee certification failure applies solely to reportable interest or dividend payments. These deduction and withholding requirements[284] are referred to as backup withholding.

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[277] Treas. Reg. sec. 1.6041-3. Certain for-profit health care provider corporations are not covered by this general exception, including those organizations providing billing services for such companies.

[278] Sec. 6721. These amounts are adjusted annually for inflation. For information returns required to be filed in calendar year 2023, the penalty amount is $290, up to a maximum of $3,532,500 per calendar year. For information returns required to be filed in calendar year 2024, the penalty amount is $310, up to a maximum of $3,783,000 per calendar year. The penalties are reduced if the failure is corrected within a specified amount of time. Sec. 6721(b). The penalties are waived if a person establishes that any failure was due to reasonable cause and not willful neglect. Sec. 6724(a).

[279] Sec. 6722. These amounts are also adjusted annually for inflation. For information statements required to be filed in calendar year 2023, the penalty amount is $290, up to a maximum of $3,532,500 per calendar year. For information statements required to be filed in calendar year 2024, the penalty amount is $310, up to a maximum of $3,783,000 per calendar year. The penalties are reduced if the failure is corrected within a specified amount of time. Sec. 6722(b). The penalties are waived if a person establishes that any failure was due to reasonable cause and not willful neglect. Sec. 6724(a).

[280] Secs. 6721(d) and 6722(d).

[281] Secs. 6721(e) and 6722(e).

[282] Sec. 3406(a)(1)(D). The backup withholding rate is the fourth lowest rate of tax applicable under section 1(c). In 2023, this rate is 24 percent.

[283] Sec. 3406(a)(1).

[284] Sec. 3406.

Reportable payments are defined as any reportable interest or dividend payment and any other reportable payment.[285] A reportable interest or dividend payment means any payment of a kind, and to a payee, required to be shown on an information return required under any of the following sections: (i) 6049(a), relating to payments of interest, (ii) 6042(a), relating to payments of dividends, or (iii) 6044, relating to payments of patronage dividends, but only to the extent such payment is in money and only if 50 percent or more of such payment is in money. Any other reportable payment means any payment of a kind, and to a payee, required to be shown on a return required under any of the following sections: (i) 6041, relating to certain information at source, (ii) 6041A(a), relating to payments of remuneration for services, (iii) 6045, relating to returns of brokers, (iv) 6050A, relating to reporting requirements of certain fishing boat operators, but only to the extent such payment is in money and represents a share of the proceeds of the catch, (v) 6050N, relating to payments of royalties, or (vi) 6050W, relating to payments made in settlement of payment card and third party settlement transactions. Examples of payments that may be subject to backup withholding include interest, dividends, rents, royalties, commissions, non-employee compensation, and broker payments.

In general, a payment is determined to be a reportable payment, and therefore subject to backup withholding, without regard to any minimum amount which must be paid before an information return is required under the applicable information reporting statute.[286]

For payments required to be shown on a return under section 6041(a) or 6041A(a), relating to certain information at the source and payments of remuneration for services, a minimum amount generally must be paid before the payment is subject to backup withholding.[287] Such payments are treated as reportable payments, and therefore subject to backup withholding, only if (i) the aggregate amount of such payment and all previous payments described in section 6041(a) or 6041A(a) by the payor to the payee during such calendar year equals or exceeds $600, (ii) the payor was required under section 6041(a) or 6041A(a) to file an information return for the preceding calendar year with respect to payments to the payee, or (iii) during the preceding calendar year, the payor made reportable payments to the payee with respect to which amounts were required to be deducted and withheld under the backup withholding requirements. Backup withholding generally applies only to payments made to U.S. persons who have failed to provide the payor with a valid IRS Form W-9, *Request for Taxpayer Identification Number and Certification*; however, it may also apply to certain payments made to persons in the absence of valid documentation of foreign status. Backup withholding does not apply to payments made to exempt recipients, including tax-exempt organizations, government entities, and certain other

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[285] Sec. 3406(b).

[286] Sec. 3406(b)(4).

[287] Sec. 3406(b)(6).

entities.[288] Thus, a payor of reportable payments generally must request that a U.S. payee (other than certain exempt recipients) furnish a Form W-9 providing that person's name and TIN.[289]

Description of Proposal

The proposal changes the information reporting threshold for certain payments to persons engaged in a trade or business[290] and payments of remuneration for services and direct sales[291] to $1,000 in a calendar year, with the threshold amount to be indexed annually for inflation in calendar years after 2024.

The proposal also makes a conforming change to the backup withholding dollar threshold[292] to align with the new $1,000 reporting threshold. Under the proposal, both the information reporting thresholds and the backup withholding thresholds are for transactions that equal or exceed $1,000 (indexed for inflation for calendar years after 2024).

Effective Date

The proposal applies with respect to payments made after December 31, 2023.

2. Enforcement provisions with respect to COVID-related employee retention credits

Present Law

Present law permits an eligible employer to claim a refundable employee retention tax credit against applicable employment taxes for calendar quarters in 2020 and 2021 in an amount equal to a percentage of the qualified wages with respect to each employee of such employer for such calendar quarter. The percentage is 50 percent of qualified wages paid after March 12, 2020, and before January 1, 2021, and 70 percent of qualified wages for calendar quarters beginning after December 31, 2020, and before January 1, 2022, subject to a maximum amount of wages per employee.[293] The statute of limitations for assessment of any amount attributable

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[288] Sec. 3406(g); Treas. Reg. sec. 31.3406(g)-1.

[289] Treas. Reg. sec. 31.3406(h)-3.

[290] Sec. 6041(a).

[291] Sec. 6041A(a), (b).

[292] Sec. 3406(b)(6).

[293] The amount of qualified wages per employee that may be taken into account in calculating the credit is increased from $10,000 per employee for all calendar quarters beginning in 2020 to $10,000 per employee per calendar quarter for calendar quarters beginning after December 31, 2020. Legislation enacted in 2020, 2021, and 2022 further modified ERTC rules and definitions, and terminated the credit for wages paid on or after October 31, 2021 (except in the case of a recovery startup business, for which the credit terminated for wages paid on or after January 1, 2022). See Coronavirus Aid, Relief, and Economic Security (CARES) Act sec. 2301 (Pub. L. No. 116-136); Taxpayer Certainty and Disaster Relief Act of 2020 secs. 206 and 207 (Pub. L. No. 116-260); American Rescue Plan Act secs. 9651 (codifying the credit in Code sec. 3134) and 80604 (Pub. L. No. 117-2); and Infrastructure and Jobs Act sec. 80604 (Pub. L. No. 117-58).

to an ERTC is extended from three years to five years for calendar quarters beginning after June 30, 2021, and before January 1, 2022.

If for any calendar quarter the amount of the credit exceeds the applicable employment taxes imposed on the eligible employer, reduced by certain other credits, the excess is treated as a refundable overpayment. Claiming the ERTC on an employment tax return as originally filed can either reduce the eligible employer's employment tax due, or if it exceeds the amount of the tax, give rise to a refund. An eligible employer may claim the employee retention credit on an amended employment tax return (Form 941-X) if the employer did not claim (or seeks to correct) the credit on its original employment tax return. For tax year 2020, an amended employment tax return must be filed by April 15, 2024, and for tax year 2021, by April 15, 2025.

Following an increase in ERTC claims, on July 26, 2023, the IRS announced new procedures to address ERTC fraud risk.[294] On September 14, 2023, the IRS announced a moratorium on processing ERTC claims.[295] On October 19, 2023, the IRS announced a process for withdrawing ERTC claims.[296] On December 21, 2023, the IRS announced a voluntary disclosure program for taxpayers that claimed and received the credit, but that are ineligible and seek to pay back the credit.[297]

Present law imposes assessable penalties on promoters of tax shelter or abusive transactions.[298] One such penalty is based on aiding and abetting the understatement of tax

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[294] See IRS July 26, 2023, announcement at https://www.irs.gov/newsroom/irs-commissioner-signals-new-phase-of-employee-retention-credit-work-with-backlog-eliminated-additional-procedures-will-be-put-in-place-to-deal-with-growing-fraud-risk. There has been publicity about ERTC "mills." See, *e.g.*, https://www.abipcpa.com/employee-retention-tax-credit-ertc-scams-and-fraud/; and https://www.jec-llc.com/blog/ertc-mills-what-should-you-look-out-for; and https://www.irs.gov/newsroom/red-flags-for-employee-retention-credit-claims-irs-reminds-businesses-to-watch-out-for-warning-signs-of-aggressive-promotion-that-can-mislead-people-into-making-improper-erc-claims.

[295] See https://www.irs.gov/newsroom/to-protect-taxpayers-from-scams-irs-orders-immediate-stop-to-new-employee-retention-credit-processing-amid-surge-of-questionable-claims-concerns-from-tax-pros.

[296] See https://www.irs.gov/newsroom/irs-announces-withdrawal-process-for-employee-retention-credit-claims-special-initiative-aimed-at-helping-businesses-concerned-about-an-ineligible-claim-amid-aggressive-marketing-scams.

[297] Expressing concerns about "misleading public advertisements and scams taking advantage of taxpayers," on December 21, 2023, the IRS announced a voluntary disclosure program permitting taxpayers to voluntarily repay the ERTC minus 20 percent through March 22, 2024. See IRS Announcement 2024-3, https://www.irs.gov/pub/irs-drop/a-24-03.pdf, and https://www.irs.gov/coronavirus/employee-retention-credit-voluntary-disclosure-program.

[298] Secs. 6700 through 6708. Sec. 6671 provides rules for application of assessable penalties, including that assessable penalties are payable on notice and demand (sec. 6671(a)).

liability, if the person knows that an understatement of the tax liability of another person would result.[299]

Separately, paid tax return preparers are subject to a penalty of $500 for each failure to comply with due diligence requirements relating to the filing status and amount of certain credits with respect to a taxpayer's return or claim for refund.[300]

Other promoter penalties are related to failure to disclose particular information with respect to a reportable transaction (generally, a transaction that the Treasury Secretary determines has the potential for tax avoidance or evasion),[301] and requires material advisors of reportable transactions to keep lists of advisees, subject to a penalty for failure.

Description of Proposal

The proposal makes penalties applicable to an ERTC promoter, as defined by the proposal. The penalties applicable to ERTC promoters are assessable without regard to the restrictions on assessment found in section 6213(a).[302] References in the proposal to the ERTC include the ERTC under both section 3134 of the Code and section 2301 of the CARES Act.

For an ERTC promoter, the assessable penalty for aiding and abetting understatement of a tax liability is increased to the greater of $200,000 ($10,000 in the case of an ERTC promoter that is a natural person) or 75 percent of the gross income of the ERTC promoter from providing aid, assistance, or advice with respect to a return or claim for ERTC refund or a document relating to the return or claim. For purposes of present-law disclosure and other requirements as well as penalties relating to reportable and listed transactions,[303] an employee retention tax credit (whether or not the taxpayer claims the credit) is treated as a listed transaction as well as a reportable transaction with respect to an ERTC promoter that provides any aid, assistance or advice with respect to the credit, and the ERTC promoter is treated as a material advisor.

The proposal specifically requires an ERTC promoter to comply with due diligence requirements[304] with respect to a taxpayer's eligibility for (or the amount of) an employee retention tax credit and applies a $1,000 penalty for each failure to comply. This amount is

[299] Sec. 6701. See also IRM, 20.1.6.14.1 (10-13-2021), Activities Subject to the Penalty: "A tax advisor would not be subject to this penalty for suggesting to a client an aggressive but supportable filing position even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. However, if the advisor suggested a position which the advisor knew could not be supported on any reasonable basis under the law, the penalty would apply."

[300] Sec. 6695(g). This is treated as an assessable penalty.

[301] Secs. 6111 and 6112.

[302] Assessable penalties are payable on notice and demand. Sec. 6671(a).

[303] Secs. 6111, 6112, 6707, and 6708.

[304] The due diligence requirements are required to be similar to the due diligence requirements of section 6695(g).

treated as an assessable penalty. In addition, if the ERTC promoter does not comply with these due diligence requirements, the proposal treats the knowledge requirement[305] as satisfied for purposes of imposing the penalty for aiding and abetting understatement of a tax liability. The due diligence requirements imposed in these circumstances apply with respect to documents that constitute, or relate to, a return or claim for refund.

Under the proposal, an ERTC promoter is any person that provides aid, assistance, or advice with respect to an affidavit, refund, claim or other document relating to an ERTC or to eligibility or to the calculation of the amount of the credit, if the person (1) charges or receives a fee based on the amount of the ERTC refund or credit, or (2) meets a gross receipts test. The gross receipts test is met if (3) the aggregate gross receipts for the relevant year from such aid equals or exceeds half of the person's gross receipts for the relevant year, or (4) both (i) the aggregate gross receipts for the relevant year from such aid exceeds 20 percent of the person's gross receipts for the relevant year and (ii) the person's aggregate gross receipts[306] from all such aid exceeds $500,000. An ERTC promoter does not include a certified professional employer organization (PEO).

The proposal extends the statute of limitations on assessment for the ERTC to six years after the latest of: (1) the date on which the original return for the relevant calendar quarter is filed, (2) the date on which the return is treated as filed under present-law statute of limitations rules,[307] or (3) the date on which the credit or refund with respect to the ERTC is made.

The proposal also provides that no credit or refund of the ERTC shall be allowed or made after January 31, 2024, unless the claim for the refund or credit is filed on or before that date.

Effective Date

The proposal is generally effective for aid, assistance, or advice provided after March 12, 2020. The part of the proposal relating to verification and due diligence is effective for aid, assistance, or advice provided after the date of enactment. The limitation on credit or refund of the ERTC applies to credits or refunds allowed or made after January 31, 2024. The extension of the statute of limitations on assessment is effective for assessments made after the date of enactment. Under a transition rule, the requirement for an ERTC promoter to file disclosures or maintain lists with respect to aid, assistance, or advice provided before the date of enactment does not require filing before 90 days after the date of enactment. No inference is intended with respect to whether an ERTC is treated as a reportable or listed transaction with respect to an ERTC promoter under present law. In addition, regulatory authority is provided.

[305] Sec. 6701(a)(3). See the present-law description of the knowledge requirement, above.

[306] For purposes of determining aggregate gross receipts, an aggregation rule provides that all persons treated as a single employer under section 52(a) or (b) are treated as one person. A rule for short taxable years applies.

[307] Sec. 6501.