DESCRIPTION OF EXPIRING BUSINESS-RELATED TAX PROVISIONS MADE PERMANENT OR EXTENDED UNDER THE "TAX REFORM ACT OF 2014," A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE

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Prepared by the Staff
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INTRODUCTION

The House Committee on Ways and Means has scheduled a hearing on those expiring business-related tax provisions that are made permanent or extended under the "Tax Reform Act of 2014," a discussion draft of the Chairman of the House Committee on Ways and Means to reform the Internal Revenue Code, released on February 26, 2014.[1] This document,[2] prepared by the staff of the Joint Committee on Taxation, provides, for each provision, a description of the present-law expiring tax provision, the legislative background, a description of the discussion draft proposal, and the effective date of the discussion draft proposal.

[1] The discussion draft also makes permanent or extends expiring tax provisions generally relating to individual taxpayers; however, these provisions are not within the scope of this document.

[2] This document may be cited as follows: Joint Committee on Taxation, *Description of Expiring Business-Related Tax Provisions Made Permanent Or Extended Under The "Tax Reform Act Of 2014," A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code* (JCX-35-14), April 4, 2014. This document may also be found on our website at www.jct.gov

EXPIRING BUSINESS-RELATED TAX PROVISIONS MADE PERMANENT OR EXTENDED IN THE DISCUSSION DRAFT OF THE "TAX REFORM ACT OF 2014"

1. Research credit modified and made permanent (sec. 41 of the Code)

Present Law

General rule

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[3] Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit.[4]

A 20-percent research credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.[5] This separate credit computation commonly is referred to as the basic research credit.[6]

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.[7] This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2013.[8]

Computation of allowable credit

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

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[3] Sec. 41(a)(1).

[4] Sec. 41(c)(5).

[5] Sec. 41(a)(2).

[6] Sec. 41(e).

[7] Sec. 41(a)(3).

[8] Sec. 41(h).

taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).[9] In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses. Slightly different rules apply in calculating the basic research credit, which generally has a base period that extends from 1981 through 1983.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[10] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[11]

Alternative simplified credit

The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years.[12] The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.[13] An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.[14]

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

[10] Sec. 41(f)(1).

[11] Sec. 41(f)(3).

[12] Sec. 41(c)(5)(A).

[13] Sec. 41(c)(5)(B).

[14] Sec. 41(c)(5)(C).

Eligible expenses

Qualified research expenses eligible for the research credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[15] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of section 174, but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[16] In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for internal use by the taxpayer; (6) conducted outside the United States, Puerto Rico, or any U.S. possession; (7) in the social sciences, arts, or humanities; or (8) funded by any grant, contract, or otherwise by another person (or government entity).[17]

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research credit determined for the taxable

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

[16] Sec. 41(d)(3).

[17] Sec. 41(d)(4).

year.[18] Taxpayers may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing deductions otherwise allowed.[19]

Legislative Background

The research credit initially was enacted in the Economic Recovery Tax Act of 1981[20] as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years.[21] The research credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate university basic research credit.[22]

The Technical and Miscellaneous Revenue Act of 1988[23] ("1988 Act") extended the research credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989[24] ("1989 Act") effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also modified the method for calculating a taxpayer's base amount (*i.e.*, by substituting the present-law method, which uses a fixed-base percentage, for the prior-law moving base which was calculated by reference to the taxpayer's average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research credit determined for the year.

The Omnibus Budget Reconciliation Act of 1990[25] extended the research credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

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[18] Sec. 280C(c).

[19] Sec. 280C(c)(3).

[20] Pub. L. No. 97-34.

[21] The research credit originally was enacted as section 44F. It subsequently was renumbered as section 30 by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, and ultimately renumbered as section 41 by the Tax Reform Act of 1986, Pub. L. No. 99-514.

[22] Pub. L. No. 99-514.

[23] Pub. L. No. 100-647.

[24] Pub. L. No. 101-239.

[25] Pub. L. No. 101-508.

The Tax Extension Act of 1991[26] extended the research credit for six months (*i.e.*, for qualified expenses incurred through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993[27] ("1993 Act") extended the research credit for three years (*i.e.*, retroactively from July 1, 1992 through June 30, 1995). The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience.

Although the research credit expired during the period July 1, 1995, through June 30, 1996, the Small Business Job Protection Act of 1996[28] ("1996 Act") extended the credit for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime). In addition, the 1996 Act expanded the definition of start-up firms under section 41(c)(3)(B)(i), enacted a special rule for certain research consortia payments under section 41(b)(3)(C), and provided that taxpayers may elect an alternative research credit regime (under which the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage otherwise applicable and the credit rate likewise is reduced) for the taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997.

The Taxpayer Relief Act of 1997[29] ("1997 Act") extended the research credit for 13 months (*i.e.*, generally for the period June 1, 1997, through June 30, 1998). The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury). The Tax and Trade Relief Extension Act of 1998[30] extended the research credit for 12 months (*i.e.*, through June 30, 1999).

The Ticket to Work and Work Incentive Improvement Act of 1999[31] extended the research credit for five years, through June 30, 2004, increased the rates of credit under the alternative incremental research credit regime, and expanded the definition of research to include research undertaken in Puerto Rico and possessions of the United States.

The Working Families Tax Relief Act of 2004[32] extended the research credit through December 31, 2005. The Energy Policy Act of 2005[33] ("2005 Act") added the energy research

[26] Pub. L. No. 102-227.

[27] Pub. L. No. 103-66.

[28] Pub. L. No. 104-188.

[29] Pub. L. No. 105-34.

[30] Pub. L. No. 105-277.

[31] Pub. L. No. 106-170.

[32] Pub. L. No. 108-311.

credit; the energy credit provides that a taxpayer may claim a credit equal to 20 percent of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium. Further, the 2005 Act increased (from 65 percent to 100 percent) the amount of eligible contract research expenses when paid to a qualified organization for qualified energy research.

The Tax Relief and Health Care Act of 2006[34] extended the research credit through December 31, 2007, modified the alternative incremental research credit, and added an election to claim an alternative simplified credit.

The Tax Extenders and the Alternative Minimum Tax Relief Act of 2008[35] ("2008 Act") extended the research credit through December 31, 2009, except for the alternative incremental research credit (which expired after December 31, 2008). The 2008 Act also increased (from 12 percent to 14 percent) the rate of credit under the alternative simplified credit.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[36] extended the research credit through December 31, 2011. The American Taxpayer Relief Act of 2012[37] extended the research credit through December 31, 2013 and modified the special rules for taxpayers under common control and the special rules for computing the credit when a major portion of a trade or business (or unit thereof) changes hands.

Description of Proposal

The discussion draft proposal makes permanent the alternative simplified method for calculating the research credit and increases the rate to 15 percent. That is, the research credit is equal to 15 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 10 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. The proposal repeals the traditional 20-percent research credit calculation method.

The proposal also makes permanent the basic research credit, but reduces the credit rate to 15 percent and changes the base period from a fixed period to a three-year rolling average. The proposal repeals the energy research credit.

The proposal eliminates the research credit with respect to research related to computer software. In addition, the proposal removes from the definition of qualified research expenses amounts paid for supplies in the conduct of qualified research. The proposal also eliminates the

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[33] Pub. L. No. 109-58.

[34] Pub. L. No. 109-432.

[35] Pub. L. No, 110-343.

[36] Pub. L. No. 111-312.

[37] Pub. L. No. 112-240.

special rules in the research credit that allow, in certain cases, for contract research expenses to exceed 65 percent of the amount actually paid for such expenses.

Finally, the proposal eliminates a taxpayer's ability to claim a reduced research credit amount in lieu of reducing research and development deductions otherwise allowed.

Effective Date

The discussion draft proposal to make various components of the research credit permanent is effective for amounts paid or incurred after December 31, 2013. The other elements of the proposal are effective for taxable years beginning after December 31, 2013.

2. Classification of certain horses as 3-year property (sec. 168 of the Code)

Present Law

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income.[38] Under the modified accelerated cost recovery system ("MACRS"), adopted in 1986, the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[39] The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[40] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset. The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property.

A three-year recovery period is assigned to: (i) any race horse (1) that is placed in service after December 31, 2008 and before January 1, 2014[41] and (2) that is placed in service after December 31, 2013 and that is more than two years old at such time it is placed in service

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[38] Sec. 167(a).

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

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

[41] Sec. 168(e)(3)(A)(i)(I), as in effect after amendment by the Heartland, Habitat, Harvest, and Horticulture Act of 2008, Title XV of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, sec. 15344(b).

by the purchaser;[42] and (ii) any horse other than a race horse if the horse is more than 12 years old at the time it is placed in service.[43]

A seven-year recovery period is assigned to: (i) any race horse that is placed in service after December 31, 2013 and that is two years old or younger at the time it is placed in service;[44] and (ii) any horse that is 12 years old or less at the time it is placed in service.[45]

Legislative Background

When originally enacted, section 168(e)(3)(A)(i) assigned a three-year recovery period to any race horse that was more than two years old at the time it was placed in service.[46] Revenue Procedure 87-56 also assigned a three-year recovery period to: (1) any breeding or work horse that is more than 12 years old at the time it is placed in service,[47] and (2) any horse other than a race horse if the horse is more than 12 years old at the time it is placed in service.[48]

The Heartland, Habitat, Harvest, and Horticulture Act of 2008,[49] modified section 168(e)(3)(A)(i) to assign a three-year recovery period to any race horse, regardless of age, that is placed in service after December 31, 2008 and before January 1, 2014. In the case of a race horse placed in service after December 31, 2013, the three-year recovery period only applies if the race horse is more than two years old when placed in service by the purchaser.

A seven-year recovery period applies to any race horse that is placed in service either prior to January 1, 2009 or after December 31, 2013 and that is two years old or younger at the time it is placed in service.[50]

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[42] Sec. 168(e)(3)(A)(i)(II). A horse is more than 2 years old after the day that is 24 months after its actual birthdate. Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785. See also, Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.223.

[43] Sec. 168(e)(3)(A)(i)(III). See also, Rev. Proc. 87-56, 1987-2 C.B. 674, asset classes 01.222 and 01.224.

[44] Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.225.

[45] *Ibid*, asset classes 01.221 and 01.225.

[46] Sec. 168(e)(3)(A)(i), prior to amendment by the Heartland, Habitat, Harvest, and Horticulture Act of 2008. See also, Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.223.

[47] Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.222.

[48] Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.224.

[49] Title XV of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, sec. 15344.

[50] Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.225.

Description of Proposal

The discussion draft proposal specifically assigns a three-year recovery period for any race horse.[51]

Effective Date

The discussion draft proposal applies to property placed in service after December 31, 2016.

3. Expensing certain depreciable business assets for small business (sec. 179 of the Code)

Present Law

A taxpayer may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation.[52] For taxable years beginning in 2013, the maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year.[53] The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000.[54] The $500,000 and $2,000,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.[55] For taxable years beginning before 2014, qualifying property also includes off-the-shelf computer software and qualified real property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[56] Of the

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[51] The proposal retains the present law three-year recovery period for any horse other than a race horse that is more than 12 years old at the time it is placed in service.

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

[53] For the years 2003 through 2006, the relevant dollar amount is $100,000 (indexed for inflation); in 2007, the dollar limitation is $125,000; for the 2008 and 2009 years, the relevant dollar amount is $250,000; and for 2010, 2011, and 2012, the relevant dollar limitation is $500,000. Sec. 179(b)(1).

[54] For the years 2003 through 2006, the relevant dollar amount is $400,000 (indexed for inflation); in 2007, the dollar limitation is $500,000; for the 2008 and 2009 years, the relevant dollar amount is $800,000; and for 2010, 2011, and 2012, the relevant dollar limitation is $2,000,000. Sec. 179(b)(2).

[55] Qualifying property does not include any property described in section 50(b), air conditioning units, or heating units. Sec. 179(d)(1). Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F. For sport utility vehicles above the 6,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is $25,000. Sec. 179(b)(5).

[56] Secs. 179(d)(1)(A)(ii) and (f).

$500,000 expense amount available under section 179, the maximum amount available with respect to qualified real property is $250,000 for each taxable year.[57]

For taxable years beginning in 2014 and thereafter, a taxpayer may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property (not including off-the-shelf computer software or qualified real property) that is purchased for use in the active conduct of a trade or business.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision).[58] Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However, amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property.[59] Thus, if a taxpayer's section 179 deduction for 2012 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2013. Any such carryover amounts that are not used in 2013 are treated as property placed in service in 2013 for purposes of computing depreciation. That is, the unused carryover amount from 2012 is considered placed in service on the first day of the 2013 taxable year.[60]

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.[61] If a corporation makes an election under section 179 to deduct expenditures, the full amount of the deduction does not reduce earnings

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[57] Sec. 179(f)(3).

[58] Sec. 179(b)(3).

[59] Section 179(f)(4) details the special rules that apply to disallowed amounts.

[60] For example, assume that during 2012, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2012, and has a taxable income limitation of $150,000. The maximum section 179 deduction the company can claim for 2012 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2013 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.

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

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

and profits. Rather, the expenditures that are deducted reduce corporate earnings and profits ratably over a five-year period.[62]

An expensing election is made under rules prescribed by the Secretary.[63] In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under section 179 may be revoked by the taxpayer without consent of the Commissioner for taxable years beginning after 2002 and before 2014.[64]

Legislative Background

A taxpayer with a sufficiently small amount of annual investment costs may elect to deduct at least a portion of those costs currently. Such rules were originally enacted in 1958 as section 179.[65] The 1958 legislation provided that a taxpayer could elect to deduct, as additional first-year depreciation, 20 percent of the cost of certain depreciable property. The cost of property eligible for this treatment was limited to $10,000, and consequently, the deduction was limited to $2,000 for the taxable year. Section 179 property was defined as depreciable property with a useful life of six years or more that was acquired by purchase after 1957 for use in a trade or business or for holding for the production of income.

In 1981, when the ACRS depreciation rules were adopted (generally providing accelerated methods and shorter recovery periods for depreciation), the section 179 rules also were revised to provide expensing of a greater amount.[66] The 1981 legislation provided that, for taxable years beginning in 1982 and 1983, a taxpayer could elect to deduct up to $5,000 of the cost of qualifying property placed in service in the taxable year. The dollar limitation was increased to $7,500 for taxable years beginning in 1984 and 1985, and increased to $10,000 for taxable years beginning in 1986 and thereafter.[67] Qualifying property was defined as property acquired by purchase for use in a trade or business (not including property held merely for the production of income). The provision was subsequently modified to provide that the dollar limitation on the deductible amount is reduced (but not below zero) by the amount by which the

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

[63] Sec. 179(c)(1).

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

[65] Small Business Tax Revision Act of 1958 [title II of H.R. 8381, the Technical Amendments Act of 1958], Pub. L. No. 85-866, sec. 204 (1958).

[66] The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, sec. 202 (1981).

[67] Subsequent legislation altered the years for which these amounts took effect. The $10,000 amount was to become effective for taxable years beginning in 1990 and thereafter, under section 13 of the Tax Reform Act of 1984, Pub. L. No. 98-369 (1984), but was made effective for taxable years beginning after 1986, under section 202 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).

cost of section 179 property placed in service during the taxable year exceeds a dollar threshold.[68]

The dollar limitation was again increased in 1993 to $17,500 for taxable years beginning after 1992.[69] In 1996, the expensing provisions were again amended to provide for the dollar limitation to increase over a period of several years, ultimately reaching $25,000 for taxable years beginning in 2003 or thereafter.[70] For the years 2003 through 2006, the relevant dollar amount was increased to $100,000 and indexed annually for inflation,[71] computer software was added to the definition of qualifying property,[72] and the section 179 election was made revocable by the taxpayer for property placed in service in such years.[73] In 2007, the dollar limitation was again increased to $125,000 and the treatment of computer software as qualified property was extended as well as the section 179 election revocability.[74] For the 2008 and 2009 years, the relevant dollar amount was increased to $250,000, the treatment of computer software as qualified property was extended, as was the section 179 election revocability.[75] For 2010, 2011, 2012, and 2013, the relevant dollar limitation is $500,000.[76] Again, the treatment of computer software as qualified property was extended through 2013 as well as the section 179 election revocability. Starting in 2010 and continuing through 2013, the definition of qualifying property

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[68] See section 202 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).

[69] The Omnibus Budget and Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13116(a) (1993).

[70] The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, sec. 1111(a) (1996).

[71] In 2003, the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-127, sec. 202(a) (2003), increased the relevant dollar amount to $100,000, indexed annually for inflation, but only for tax years beginning after 2002 and before 2006; the American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 201 (2004), extended these increased amounts through taxable years beginning before 2008 and sec. 910(a) of such Act added the section 179 limitation applicable to sport utility vehicles; the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 101 (2005), further extended these amounts through taxable years beginning before 2010.

[72] The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-127, sec. 202(c) (2003).

[73] The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-127, sec. 202(e) (2003).

[74] The Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, sec. 8212 (2007), increased the relevant amount to $125,000 for taxable years beginning in 2007.

[75] The Economic Stimulus Act of 2008, Pub. L. No. 110-185, sec. 102(a) (2008), increased the relevant amount to $250,000 for 2008 with the limitation returning to $125,000 for 2009 and 2010. However, the American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5, sec. 1202(a)(1) and (2) (2009), and the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 201(a)(1)-(4) (2010), extended the increase to $250,000 for the 2009 and 2010 years, respectively.

[76] The Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2021(a)(1) and (2) (2010), increased the relevant limitation to $500,000 for the 2010 and 2011, with the amount returning to $25,000 starting in 2012. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 402 (2010), increased the relevant limitation for 2012 to 125,000, with the amount returning to $25,000 starting in 2013. However, the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 315 (2012), extended the increase to $500,000 for the 2012 and 2013 years.

also included qualified real property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[77] For 2014 and all subsequent years, the relevant dollar limitation returns to $25,000.[78] While the annual dollar limitation is often deemed the most significant rule under section 179, certain additional rules govern section 179 computations and eligibility and the coordination of section 179 with other rules.[79]

Description of Proposal

The discussion draft proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2013, is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 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 $800,000. The $250,000 and $800,000 amounts are indexed for inflation for taxable years beginning after 2014.

In addition, the proposal makes permanent, for taxable years beginning after 2013, the treatment of off-the-shelf computer software as qualifying property. The proposal also makes permanent the treatment of qualified real property as eligible section 179 property for taxable years beginning after 2013.

The proposal permits the taxpayer to revoke any election and any specification contained therein, made under section 179 after 2002.

Further, the proposal strikes the flush language in section 179(d)(1) that excludes air conditioning and heating units from the definition of qualifying property.

Effective Date

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

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[77] Secs. 179 (f). The Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2021(b) (2010) added qualified real property to the definition of section 179 eligible property for 2010 and 2011. The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 315 (2012) extended the treatment of qualified real property as eligible section 179 property through 2013.

[78] Sec. 179(b)(1)(C).

[79] The amount eligible to be expensed for a taxable year may not exceed the taxable income derived in that year from the active conduct of a trade or business (determined without regard to section 179). 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 similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under certain rules prescribed by the Secretary. An expensing election was allowed for qualified real property in taxable years beginning in 2010, 2011, 2012 or 2013 (sec. 179(f)(4)).

4. Exceptions for active financing income (secs. 953 and 954 of the Code)

Present Law

Under the subpart F rules,[80] 10-percent-or-greater U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (*i.e.*, income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

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

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[81]

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

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is

[80] Secs. 951-964.

[81] Prop. Treas. Reg. sec. 1.953-1(a).

eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

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

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

Legislative Background

The provision was enacted in the Taxpayer Relief Act of 1997,[82] effective for taxable years beginning in 1998.

[82] Pub. L. No. 105-34.

The provision was substantially modified and extended for one year in the Tax and Trade Relief Extension Act of 1998.[83] The 1998 Act modified the definition of income derived in the active conduct of a banking, financing, or similar business to add substantial activity and nexus requirements, to change the test for whether a CFC is predominantly engaged in such active conduct, to change the treatment of cross-border transactions, to change the determination of where a customer is located, and to eliminate a look-through rule for determining eligible income. The 1998 Act modified the definition of income derived in the conduct of an insurance business to change the determination of reserves and to provide additional exceptions for certain income of a qualifying branch with respect to risks located within the home country of the branch, and for certain CFCs or branches located in any country other than the United States. The provision was substantially modified and extended for five years in the Job Creation and Worker Assistance Act of 2002.[84] The 2002 Act modification, which relates to income derived in the conduct of an insurance business, permits the use of foreign statement reserves subject to IRS approval. In 2004, a definition of "direct conduct of activities" was added to section 954(h)(9) by the American Jobs Creation Act of 2004.[85] The provision was extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[86] for taxable years beginning before 2012.

The provision was most recently extended for two years by The American Taxpayer Relief Act of 2012,[87] for taxable years beginning before 2014.

Description of Proposal

The discussion draft proposal modifies and extends for five years (for taxable years beginning before January 1, 2019) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Under the proposal, foreign personal holding company income does not include any item of qualified banking or financing income of an eligible controlled foreign corporation (as determined under 954(h)), or qualified insurance income of a qualifying insurance company (as determined under 954(i)), which is subject to an effective foreign income tax rate of at least 50 percent of the maximum U.S. corporate rate under section 11.

[83] Pub. L. No. 105-277.

[84] Pub. L. No. 107-147.

[85] Pub. L. No. 108-357.

[86] Pub. L. No. 111-312.

[87] Pub. L. No. 112-240.

The proposal also excludes from foreign personal holding company income 50 percent of any other item of qualified banking or financing income of an eligible controlled foreign corporation, or qualified insurance income of a qualifying insurance company.

Under the proposal, with respect to such items of income to which the 50-percent exclusion from foreign personal holding company income applies, the determination of taxes deemed paid by a United States shareholder under section 960(a) is made as if no 50-percent exclusion were allowed. In other words, a United States shareholder is deemed to pay the pro rata share of the full amount of tax paid by the controlled foreign corporation on such item of income.

Effective Date

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

5. Look-thru treatment of payments between related controlled foreign corporations under foreign personal holding company rules (sec. 954(c)(6) of the Code)

Present Law

In general

The rules of subpart F[88] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

[88] Secs. 951-964.

The “look-thru rule”

Under the “look-thru rule”[89], dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received or accrued by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC’s stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-thru rule, including such regulations as are necessary or appropriate to prevent the abuse of the purposes of such rule.

The look-thru rule applies to taxable years of foreign corporations beginning after December 31, 2005 and before January 1, 2014, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Legislative Background

The provision was enacted in the Tax Increase Prevention and Reconciliation Act of 2005[90] applicable taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The provision was amended in the Tax Relief and Health Care Act of 2006[91] to exclude from the look-thru rule related party payments which are treated as effectively connected income of the paying CFC. Additionally, the amendment modified the regulatory authority. Prior to the amendment, the provision directed the Secretary to prescribe regulations as may be appropriate to prevent the abuse of the purposes of the provision. After the amendment, the provision directs the Secretary to prescribe regulations necessary or appropriate to carry out the purposes of the provision, including regulations necessary or appropriate to prevent abuse of the purposes of the provision.

The provision was amended in the Tax Technical Corrections Act of 2007[92] to exclude from eligibility for the look-thru rule any interest, rent, or royalty to the extent that interest, rent, or royalty creates (or increases) a deficit that under section 952(c) may reduce the subpart F income of the payor or another controlled foreign corporation.

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[89] Sec. 954(c)(6).

[90] Pub. L. No. 109-222.

[91] Pub. L. No. 109-432.

[92] Pub. L. No. 110-172.

The provision was extended for one year in the Tax Extenders and Alternative Minimum Tax Relief Act of 2008[93] for taxable years of foreign corporations beginning before January 1, 2010, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The provision was extended for two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[94] for taxable years of foreign corporations beginning before January 1, 2012, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The provision was extended for two years by the American Taxpayer Relief Act of 2012[95] for taxable years of foreign corporations beginning before January 1, 2014, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Description of Proposal

The discussion draft proposal makes the application of the look-thru rule permanent.

Effective Date

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

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[93] Pub. L. No. 110-343.

[94] Pub. L. No. 111-312.

[95] Pub. L. No. 112-240.

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

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[96] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[97]

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

Legislative Background

The provision was enacted in the Pension Protection Act of 2006[98] for contributions made in taxable years beginning after 2005 and before 2008. The provision was extended for two years through 2009 by the Tax Extenders and Alternative Miniumum Tax Relief Act of 2008,[99] was extended for two additional years through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[100] and was extended an additional two years through 2013 by the American Taxpayer Relief Act of 2012.[101]

Desription of Proposal

The discussion draft proposal makes the provision permanent.

Effective Date

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

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[96] Sec. 1366(a)(1)(A).

[97] Sec. 1367(a)(2)(B).

[98] Pub. L. No. 109-280.

[99] Division C of Pub. L. No. 110-343.

[100] Pub. L. No. 111-312.

[101] Pub. L. No. 112-240.

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

Present Law

In general

S corporations

A small business corporation[102] may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[103]

A corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain[104] that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, (*i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect).[105] If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no built-in gain tax is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.[106] Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method [107] during or after the recognition period, that income is subject to the built-in gain tax.[108]

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporation.[109] In the case of such a transaction, the

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[102] This term is defined in section 1361(b).

[103] Sec. 1366.

[104] Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

[105] Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d).

[106] Sec. 1374(d)(2).

[107] Section 453.

[108] Treas. Reg. sec. 1.1374-4(h).

[109] Sec. 1374(d)(8).

recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[110]

The amount of the built-in gains tax is treated as a loss by each of the S corporation shareholders in computing its own income tax.[111]

Application to real estate investment trusts and regulated investment corporations

Under Treasury regulations, a regulated investment company ("RIC") or a real estate investment trust ("REIT") that was formerly a C corporation not taxed as a REIT or RIC (or that acquired assets from such a C corporation) generally is subject to the built-in gain tax rules as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment, requiring recognition of all C corporation built-in gain and loss at the time of the conversion or asset acquisition. Deemed sale treatment is not permitted if its application would result in the recognition of a net loss. For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.[112]

Legislative Background

For taxable years beginning in 2009 and 2010, the American Recovery and Reinvestment Tax Act of 2009 generally reduced to seven years the 10-year period for recognition of built-in gains by S corporations and by REITs or RICs that were formerly C corporations of acquired assets from C corporations.[113] The Small Business Jobs Act of 2010 reduced the 10-year period to five years for taxable years beginning in 2011.[114] The Taxpayer Relief Act of 2012 extended that reduction though taxable years beginning in 2012 and 2013, and incorporated a rule for installment sales where the sale, or the receipt of sales proceeds, might occur in a period in which the temporary provision was not in force.[115]

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[110] Sec. 1374(d)(8)(B).

[111] Sec. 1366(f)(2). Shareholders continue to take into account all items of gain and loss under section 1366.

[112] Treas. Reg. secs. 1.337(d)-7(b)(1) and (c)(1).

[113] Pub. L. No. 111-5. For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year. Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

[114] Pub. L. No. 111-240.

[115] *Ibid.*

Description of Proposal

For S corporations, the discussion draft proposal makes permanent the five-year recognition period.

For REITs and RICs, the discussion draft proposal generally requires immediate recognition of C corporation gain and loss on assets at the time of conversion to REIT or RIC status, or transfer of one or more C corporation assets to a REIT or RIC in a transaction in which the basis of such asset or assets is determined in whole or in part by reference to the basis in the hands of the C corporation. However, the provision does not apply if it would result in recognition of a net loss, defined as the excess of aggregate losses over aggregate gains (including items of income) without regard to character.

Effective Date

The discussion draft proposal that permanently extends the five-year built in gain recognition period for S corporations is effective for taxable years beginning after December 31, 2013.

The discussion draft proposal that requires immediate recognition of gain on conversion to a REIT or RIC, or on the transfer of C corporation assets to a REIT or RIC, is effective for elections and transfers on or after February 26, 2014.