DESCRIPTION OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE COMMITTEE PRINT RELATING TO INFRASTRUCTURE FINANCING (SUBTITLE F), GREEN ENERGY (SUBTITLE G), THE SOCIAL SAFETY NET (SUBTITLE H), AND PRESCRIPTION DRUG PRICING (SUBTITLE J)

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on September 14, 2021

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of budget reconciliation legislative recommendations relating to infrastructure financing (subtitle F), green energy (subtitle G), the social safety net (subtitle H), responsibly funding our priorities (subtitle I), and prescription drug pricing (subtitle J). This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Amendment in the nature of a substitute to the committee print relating to subtitles F, G, H, and J.

The Chairman's amendment in the nature of a substitute makes the following modifications:[2]

- Makes certain changes to the possessions economic activity credit (subtitle F, section 135701) described immediately below.
- Adds the provisions described in this document under a new subtitle I, Responsibly Funding our Priorities.

Section 135701 of subtitle F is amended by adding a defined subset of qualified domestic corporations as "qualified small domestic corporations" that may claim an enhanced possessions wage credit.

The enhanced credit is available to qualified small domestic corporations (including any foreign subsidiaries that are themselves qualified corporations) which have average annual gross receipts of no more than $50 million in the three-year test period and no more than 30 employees group-wide, at least five of whom are full-time employees in a U.S. possession. For employers within these parameters, the possession wage credit is increased from 20 percent to 50 percent of eligible possessions wages and allocable fringe benefits for each employee. In addition, the maximum amount of wages taken into account for each such employee is increased from $50,000 per employee to $139,500 per employee. For purposes of determining eligibility for the enhanced credit, the gross receipts and number of employees of other persons who would be

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to the Committee Print Relating to Infrastructure Financing (Subtitle F), Green Energy (Subtitle G), The Social Safety Net (Subtitle H), and Prescription Drug Pricing (Subtitle J)* (JCX-43-21), September 13, 2021. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references herein are to the Internal Revenue Code of 1986, as amended (herein "Code"), unless otherwise stated.

[2] The Chairman's amendment in the nature of a substitute also renumbers as section 136801 (Appropriations) a provision that was erroneously numbered as section 136701 in the committee print. For detail on the other subtitles contained in the Chairman's amendment in the nature of a substitute, see Joint Committee on Taxation, *Description of Subtitle F—Infrastructure Financing and Community Development: Budget Reconciliation Legislative Recommendations* (JCX-36-21), September 11, 2021, Joint Committee on Taxation, *Description of Subtitle G—Green Energy: Budget Reconciliation Legislative Recommendations* (JCX-38-21), September 11, 2021, Joint Committee on Taxation, *Description of Subtitle H—Social Safety Net: Budget Reconciliation Legislative Recommendations* (JCX-39-21), September 11, 2021, Joint Committee on Taxation, *Description of Subtitle J—Drug Pricing: Budget Reconciliation Legislative Recommendations* (JCX-40-21), September 11, 2021. These documents be found on the Joint Committee on Taxation website at www.jct.gov.

considered related to the qualified small domestic corporation for purposes of section 52 are taken into account. These rules treat corporations, partnerships (and other noncorporate entities such as sole proprietorships) as a single employer and generally apply to entities linked through 50-percent-or-greater direct ownership interests. Foreign entities are included.[3]

[3] Section 52(a) references section 1563(a) and section 52(b) applies using principles similar to the principles of section 52(a). For purposes of section 1563(a), the exclusions in 1563(b) are not relevant and thus both domestic and foreign entities are subject to aggregation under section 52.

A. Corporate Tax Rate

1. Increase in corporate tax rate

Present Law

In general

Corporate taxable income is generally subject to a tax rate of 21 percent.[4] While no separate rate structure exists for corporate capital gains, a corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year.

Dividends-received deduction

Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations.[5] The amount of the deduction is generally equal to 50 percent of the dividend received.

In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction is equal to 65 percent of the dividend received.[6] The term "20-percent owned corporation" means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account.

In the case of a dividend received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100 percent of the dividend received.[7]

Description of Proposal

Corporate tax rate

The proposal taxes corporate taxable income under a three-step graduated rate structure. The top corporate tax rate is 26.5 percent on taxable income in excess of $5,000,000. The corporate taxable income brackets and tax rates are as set forth in the table below.

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[4] Sec. 11.

[5] Sec. 243(a).

[6] Sec. 243(c).

[7] Sec. 243(a)(3) and (b)(1). For this purpose, the term "affiliated group" generally has the meaning given such term by section 1504(a). Sec. 243(b)(2).

Taxable Income	Tax rate (percent)
Not over $400,000	18
Over $400,000 but not over $5,000,000	21
Over $5,000,000	26.5

An additional three-percent tax is imposed on a corporation's taxable income in excess of $10,000,000. The maximum additional tax is $287,000.

Certain personal service corporations[8] pay tax on their entire taxable income at the rate of 26.5 percent.

In addition, for taxpayers subject to the normalization method of accounting (*e.g.*, regulated public utilities), the provision clarifies the normalization of the tax reserve deficit resulting from the change in the corporate income tax rate structure (with respect to prior depreciation or recovery allowances taken on assets placed in service as of the day before the corporate rate change takes effect).

The tax reserve deficit is the difference in the reserve for deferred taxes as of the day before the corporate rate change takes effect compared to what the reserve would have been if the corporate rate change had been in effect for all prior periods. If a tax reserve deficit is reduced less rapidly or to a lesser extent than such reserve would be reduced under the average rate assumption method, the taxpayer will not be treated as using a normalization method with respect to the corporate rate change. If the taxpayer does not use a normalization method of accounting for the corporate rate change, such taxpayer will not be treated as using a normalization method of accounting for purposes of section 168(f)(2) and (i)(9)(C).

The average rate assumption method reduces the tax reserve deficit over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes during the years in which the deferred tax reserve related to such property is reversing. Under this method, the tax reserve deficit is reduced as the timing differences (*i.e.*, differences between tax depreciation and regulatory depreciation with respect to the property) reverse over the remaining life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. To ensure that the deferred tax reserve, including the tax reserve deficit, is reduced to zero at the end of the regulatory life of the asset that generated the reserve, the amount of the timing difference which reverses during a taxable year is multiplied by the ratio of (1) the aggregate deferred taxes as of the beginning of the period in question, to (2) the aggregate timing differences for the property as of the beginning of the period in question.

Instead of the average rate assumption method, a taxpayer may also use the alternative method as its normalization method if certain requirements are met. If, as of the first day of the

[8] As defined in section 448(d)(2).

taxable year that includes the date of enactment, (i) the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and (ii) the taxpayer's books and underlying records do not contain the vintage account data necessary to apply the average rate assumption method,[9] the taxpayer is treated as using a normalization method of accounting if, with respect to such jurisdiction, the taxpayer uses the alternative method for public utility property that is subject to the regulatory authority for that jurisdiction.[10] Under the alternative method, the taxpayer (i) computes the tax reserve deficit on all public utility property included in the plant account based on the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (ii) reduces the tax reserve deficit ratably over the remaining regulatory life of the property.[11]

The Secretary is directed to issue regulations or other guidance the Secretary determines is necessary or appropriate to carry out the normalization requirements, including regulations or other guidance to provide appropriate coordination between the proposal, section 13001(d) of Public Law 115-97, and section 203(e) of the Tax Reform Act of 1986.[12]

Dividends-received deduction

The proposal increases the 50 percent dividends-received deduction to 60 percent and the 65 percent dividends-received deduction to 72.5 percent.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

[9] See, *e.g.*, in the case of corporate tax rate reductions, sec. 2.05 of Rev. Proc. 88-12, 1988-1 C.B. 637, and secs. 2.07 and 2.08 of Rev. Proc. 2020-39, 2020-36 I.R.B. 546.

[10] If a taxpayer is subject to the jurisdiction of more than one regulatory body, the taxpayer may use a single method, provided that the regulatory bodies agree. See sec. 4.01(5) of 2020-39, 2020-36 I.R.B. 546.

[11] See, *e.g.*, in the case of corporate tax rate reductions, sec 4 of Rev. Proc. 88-12, 1988-1 C.B. 637, and sec. 2.08 of Rev. Proc. 2020-39, 2020-36 I.R.B. 546.

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

B. Limitations on Deduction for Interest Expense

1. Limitations on deduction for interest expense

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.[13] In particular, the deduction for business interest expense[14] is generally limited to the sum of (1) business interest income of the taxpayer for the taxable year,[15] (2) 30 percent of the adjusted taxable income[16] of the taxpayer for the taxable year (not less than zero), and (3) the floor plan financing interest[17] of the taxpayer for the

[13] Sec. 163(a). In addition to the limitations discussed herein, other limitations 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)). Interest may also be subject to capitalization. See, *e.g.*, secs 263A(f) and 461(g).

[14] 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.*, secs. 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. secs. 1.163(j)-3(b)(2)-(6).

[15] 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).

[16] 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; and (4) the amount of any deduction allowed under section 199A. Additionally, for taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to any deduction allowable for depreciation, amortization, or depletion. For taxable years beginning after December 31, 2021, adjusted taxable income is computed with regard to deductions allowable for depreciation, amortization, or depletion. Sec. 163(j)(8)(A). Treasury regulations provide other adjustments to the definition of adjusted taxable income. Treas. Reg. sec. 1.163(j)-1(b)(1).

[17] 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).

taxable year.[18] 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. The amount of any business interest expense not allowed as a deduction for any taxable year may be carried forward indefinitely.

The limitation generally applies at the taxpayer level (although special carryforward 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.[19]

Carryforward of disallowed business interest

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. Such business interest expense may be carried forward indefinitely.[20]

Application to passthrough entities

In general

In the case of a partnership, the business interest limitation is generally applied at the partnership level.[21] Once business interest is determined to be deductible at the partnership level, the deduction is allocated to the partners and not tested again at the partner level. Disallowed business interest expense, or excess business interest expense ("EBIE"), is carried forward at the partner level, but is not allocated to the partner until the partnership can allocate to the partner taxable income that can support such business interest expense deduction, or excess taxable income ("ETI"), or until the partnership can allocate to the partner excess business interest income ("EBII").

A partner generally must perform its own section 163(j) calculation for business interest expense it incurs at the partner level. To prevent double counting, the business interest income and adjusted taxable income of each partner are generally determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of the partnership.[22] However, in cases where the partnership has an excess amount of business interest income, an

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[18] 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 section 163(j)(10). The proposal is effective for tax years beginning after 2021.

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

[20] 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).

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

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

excess amount of adjusted taxable income, or both, section 163(j) may allow for partnership items to 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 EBII and 30 percent of the partner's distributive share of the partnership's ETI.[23]

Similar rules apply with respect to any S corporation and its shareholders.[24]

Carryforward rules for partnerships

Special rules for the carryforward of disallowed business interest expense apply only to partnerships and their partners.[25] Partnerships deduct BIE arising at the partnership level to the extent allowed by section 163(j). Unlike other taxpayers, however, partnerships do not treat BIE suspended under section 163(j) for a tax year as BIE paid or accrued by the partnership in the succeeding tax year. Instead, the disallowed amount creates a partner-level tax attribute, excess business interest expense ("EBIE"). The statute provides that a partnership's EBIE is allocated to each partner in the same manner as the partnership's non-separately stated taxable income or loss and that EBIE allocated to a partner may be deducted by that partner in succeeding tax years only to the extent the partner is allocated excess taxable income ("ETI") or excess business interest income ("EBII") from the same partnership and from the same activities of which gave rise to the disallowed business interest expense carryforward.[26] ETI is generally a partnership's ATI that is not used to support a partnership-level BIE deduction. EBII is generally a partnership's BII that is not used to support a partnership-level BIE deduction. Any amount that is not allowed as a deduction generally continues to be carried forward.

Thus, for example, a partner that is allocated EBIE in a particular year that also has ATI from other sources in that year is not able to deduct any of the EBIE to reduce its taxable income from other sources. Instead, the partner will be able to deduct the EBIE only if and when, in a subsequent year, the same partnership allocates the partner ETI.

Section 163(j) requires that a partner perform its own section 163(j) calculation for BIE it incurs. The statute provides that a partner generally computes its ATI without regard to the partner's distributive share of any items of income, gain, deduction, or loss from a partnership. A partner may, however, increase its ATI by the partner's distributive share of a partnership's ETI, which is allocated to each partner in the same manner as the partnership's non-separately stated taxable income or loss. More specifically, ETI must first be used by a partner to apply against any EBIE allocated by the same partnership and carried forward by the partner. Once all

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

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

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

[26] 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).

such EBIE has been treated as used by the partner as a result of the allocation of ETI, any additional ETI is taken into account by the partner in computing the partner's ATI.

All amounts of business interest expense, including EBIE, decrease the partner's basis in the partnership interest. When the partner disposes of a portion of or all of its partnership interest, special rules provide for add-back adjustments to a partner's basis in its partnership interest for EBIE that had previously decreased the partner's basis in the partnership interest.[27]

These special carryforward rules do not apply to S corporations and their shareholders.[28]

Exceptions

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).[29] Aggregation rules apply to determine the amount of a taxpayer's gross receipts under the gross receipts test of section 448(c).

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation.[30] As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (*i.e.*, any electing real property trade or business) is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.[31] Similarly, at the taxpayer's election, any farming business or any business engaged in the trade or business of a specified agricultural or horticultural cooperative (collectively, any electing farming business) is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to any such trade or business.[32] A taxpayer's election to be an electing real property trade or business or an electing farming business, once made, shall be irrevocable.[33]

[27] See sec. 163(j)(4)(B).

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

[29] Sec. 163(j)(3). The $25 million amount is indexed for inflation for taxable years beginning after 2018. For taxable years beginning in 2021, the limitation is $26 million. See Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

[30] Sec. 163(j)(7)(A)(i).

[31] Sec. 163(j)(7)(A)(ii) and (B).

[32] Sec. 163(j)(7)(A)(iii) and (C).

[33] Secs. 163(j)(7)(B) and (C). In Rev. Proc. 2020-22, 2020-18 I.R.B. 1, the IRS provided guidance for making an election to be an electing real property trade or business or an electing farming business. The revenue procedure allows certain taxpayers to make a late election, or to withdraw an election, to be an electing real property

The limitation does not apply to certain regulated public utilities. Specifically, 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 is not treated as a trade or business for purposes of the limitation, and thus any interest paid or accrued on indebtedness properly allocable to such trades or businesses is not business interest.[34]

Treasury regulations under section 385

Section 385 authorizes the Secretary to prescribe regulations to determine whether an interest in a corporation is debt or equity. In 2016, Treasury issued final regulations under section 385 setting out certain dispositive factors in the determination of whether an interest is debt or equity.[35] Certain of the factors finalized in 2016, primarily related to requirements that the instrument be documented as debt contemporaneous with its issuance, were removed by final regulation in 2019.[36] Based on the application of the remaining factors, which generally address corporate distribution fact patterns, a purported debt instrument issued to a related party may be recharacterized as equity, in which case, among other consequences, payments with respect to the instrument may not be characterized as payments of interest.

The rules generally apply to a "covered debt instrument" issued by a domestic corporation to a member of the issuer's "expanded group." Generally, a covered debt instrument is a debt instrument that is not a qualified dealer debt instrument[37] or an excluded statutory or regulatory debt instrument,[38] and that is issued by a group member that is not one of certain

trade or business or electing farming on an amended Federal income tax return, an amended Form 1065, or an administrative adjustment request under section 6227. In Rev. Proc. 2020-23, 2020-18 I.R.B. 1, the IRS provided guidance allowing certain partnerships to file an amended Form 1065, and to issue amended Schedules K-1, for taxable years beginning in 2018 and 2019. As a result, the IRS, for example, will allow certain partnerships to withdraw an election to be an electing real property trade or business made on a statement attached to a 2018 Form 1065 by filing an amended 2018 Form 1065.

[34] Sec. 163(j)(7)(A)(iv).

[35] TD 9790, 81 Fed. Reg. 72858, October 26, 2016.

[36] TD 9880, 84 Fed. Reg. 59297, November 4, 2019.

[37] Generally, a qualified dealer debt instrument is a debt instrument that is issued to or acquired by a group member that is a dealer in securities in the ordinary course of the dealer's business, subject to certain requirements. See Treas. Reg. sec. 1.385-3(g)(3)(ii).

[38] Generally, an excluded statutory or regulatory debt instrument is a debt instrument that meets one of several definitions of specific types of debt instruments that receive special tax treatment under the Code or Treasury regulations. See Treas. Reg. sec. 1.385-3(g)(3)(iii).

types of regulated financial companies[39] or regulated insurance companies.[40] "Expanded group" is generally defined as a group of corporations (whether domestic or foreign) connected by chains of 80 percent ownership (by vote or value) to a common corporate parent.[41]

Generally, if a domestic corporation issues a covered debt instrument to a member of its expanded group as a distribution either on its stock (*e.g.*, a return of capital distribution under section 301(c)(2)) or in certain exchanges for stock of any member of the group, the regulations recharacterize the debt instrument as equity. Additionally, if the domestic corporation issues the debt instrument to a member of its group in exchange for money or other property and that money or other property funds either a distribution to a member of the group or certain acquisitions of group member stock or assets,[42] the regulations may recharacterize the debt instrument as equity (the "funding rule"). Generally, a covered debt instrument is treated as funding a distribution or acquisition if it is issued at any time during the period beginning 36 months before the distribution or acquisition and ending 36 months after the distribution or acquisition.[43] The funding rule does not apply to certain short-term debt instruments.[44] Additionally, the amount of purported debt recharacterized as equity by the rules discussed above may be reduced if the issuing corporation has earnings and profits or receives additional equity investment.[45]

Finally, if a corporation enters into a transaction with a principal purpose of avoiding application of the regulations, the regulations may recharacterize certain "interests" (presumably purported debt instruments between related parties) held by members of the corporation's expanded group as stock, depending on the facts and circumstances.[46]

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[39] See Treas. Reg. sec. 1.385-3(g)(3)(iv).

[40] See Treas. Reg. sec. 1.385-3(g)(3)(v).

[41] More specifically, an expanded group is defined as one or more chains of corporations (other than S corporations) connected through stock ownership with a common parent corporation (other than an S corporation, a RIC, or a REIT) where (1) the parent owns, directly or indirectly, at least 80 percent, by vote or value, of one of the other corporations and (2) 80 percent by vote or value of the stock of each of the other corporations is owned directly or indirectly by one or more of the other corporations. See Treas. Reg. 1.385-1(c)(4).

[42] See Treas. Reg. sec.1.385-3(b)(2), (b)(3)(i), and (c)(2).

[43] Treas. Reg. sec. 1.385-3(b)(3)(iii).

[44] See Treas. Reg. sec. 1.385-3(b)(3)(vii)(A) - (D).

[45] See Treas. Reg. sec. 1.385-3(c)(3)(i) and (ii).

[46] See Treas. Reg. sec. 1.385-3(b)(4).

Special rules provide for application of the regulations to controlled partnerships[47] and consolidated groups.[48]

Description of Proposal

The proposal limits the amount of net interest expense (*i.e.*, interest expense in excess of interest income) deductible by a "specified domestic corporation," defined as a domestic corporation which is a member of a multinational group that prepares consolidated financial statements (an "international financial reporting group") and which has averaged business interest expense for the three-year reporting period ending with such reporting year of more than $12M annually. For such specified domestic corporations, the deductible amount of interest is capped at the "allowable percentage" of 110 percent of its net interest expense reported on the group's financial statements. Domestic corporations that may be classified as specified domestic corporations include foreign corporations that are engaged in a U.S. trade or business.

The member's allowable percentage of the group's net interest expense for any reporting year is equal to the ratio of (a) the member's "allocable share" of the international financial reporting group's reported net interest expense over (b) such corporation's reported net interest expense. The member's allocable share of the international financial reporting group's reported net interest expense is equal to the ratio of (a) the member's financial statement earnings (computed by adding back net interest expense, taxes, depreciation, depletion, and amortization) "("EBITDA") to (b) the group's financial statement EBITDA.

The proposal's limitation would operate concurrently with the limitation applicable to partnerships under section 163(j)(4), and the amount of interest that may be deductible in any tax year would be determined by the more restrictive of the two limitations.

Any interest deduction that is disallowed as a result of the proposal is carried forward for up to five tax years after the tax year in which such interest was so paid or accrued.

The proposal gives the Secretary of the Treasury authority to address several issues, including coordination with section 163(j)(4)) and ability to include or exclude any corporation as a member of any international financial reporting group.

The proposal modifies the rules with respect to business interest expense incurred by partnerships and S corporations. Under the proposal, the limitation with respect to business interest expense is applied at the partner level and at the S corporation shareholder level. Transition rules are provided.

Effective Date

The proposal is effective to taxable years beginning after December 31, 2021.

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[47] See generally Treas. Reg. sec. 1.385-3(f).

[48] See Treas. Reg. sec. 1.385-4.

C. Outbound International Provisions

1. Modifications to deduction for foreign-derived intangible income and global intangible low-taxed income

Present Law

Deduction percentages for FDII and GILTI

Domestic corporations generally are taxed at preferential rates on their foreign-derived intangible income ("FDII") and their global intangible low-taxed income ("GILTI") by means of a deduction under section 250.

The preferential rate on FDII is achieved by allowing corporations a deduction equal to 37.5 percent of their FDII.[49] For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent.[50]

The preferential rate on GILTI is achieved by allowing corporations a deduction equal to 50 percent of their GILTI (including the corresponding section 78 gross-up amount).[51] For taxable years beginning after December 31, 2025, the deduction for GILTI is reduced to 37.5 percent.[52]

Taxable income limitation

If the sum of a domestic corporation's FDII and GILTI exceeds its taxable income determined without regard to section 250, then the amount of FDII and GILTI (including the corresponding section 78 gross-up amount) for which a deduction is allowed is reduced (but not below zero) by an amount determined by such excess. The deduction under section 250 is not taken into account for purposes of determining a net operating loss ("NOL") of the taxpayer.[53]

Description of Proposal

The proposal changes the percentages with respect to FDII and GILTI. The percentage for FDII is changed to 21.875 percent (from 37.5 percent) and the percentage for GILTI is

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

[50] Sec. 250(a)(3)(A). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on FDII is 13.125 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on FDII is 16.406 percent.

[51] Sec. 250(a)(1)(B). Under section 78, a taxpayer claiming the foreign tax credit with respect to foreign-source income generally must include in income the amount of the related foreign taxes paid.

[52] Sec. 250(a)(3)(B). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on GILTI is 10.5 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on GILTI is 13.125 percent.

[53] Sec. 172(d)(9).

changed to 37.5 percent (from 50 percent). In other words, the proposal accelerates the changes that under current law are in effect for taxable years beginning after December 31, 2025.

The proposal repeals the taxable income limitation and allows for the deduction under section under section 250 to be taken into account for purposes of determining the NOL of the taxpayer.

Effective Date

The proposal generally is effective for taxable years beginning after December 31, 2021.

The proposal provides a transition rule for fiscal-year taxpayers. In the case of any taxable year which includes December 31, 2021 (other than a taxable year with respect to which such date is the last day of such taxable year) the percentage in effect for FDII is treated as being equal to the sum of (i) the pre-effective date percentage of 37.5 percent plus (ii) the post-effective date percentage of 21.875 percent, and the percentage in effect for GILTI (including the corresponding section 78 gross-up amount) is treated as being equal to the sum of (i) the pre-effective date percentage of 50 percent plus (ii) the post-effective date percentage of 37.5 percent.

For purposes of the transition rule, with respect to any taxable year, the pre-effective date percentage means the ratio that the portion of such taxable year which precedes January 1, 2022, bears to the entire taxable year and the post-effective date percentage means the ratio that the remainder of such taxable year bears to the entire taxable year.

2. Repeal of election for one-month deferral in determination of taxable year of specified foreign corporations

Present Law

In general, controlled foreign corporations ("CFCs") and other specified foreign corporations are required to use as a taxable year the taxable year of their majority U.S. shareholder (the "majority U.S. shareholder year").[54] A CFC, however, may elect a taxable year beginning one month earlier than the majority U.S. shareholder year (a "one-month deferral year").

Description of Proposal

The proposal repeals the election for a one-month deferral year. Thus, a CFC using a one-month deferral year is required to change to use its majority U.S. shareholder year.

[54] Sec. 898(a) and (c).

Effective Date

The proposal applies to taxable years of specified foreign corporations which would (but for the amendments made by the proposal) begin after November 30, 2021.

A transition rule provides that a taxpayer's first taxable year beginning after November 30, 2021, ends at the same time as the first required year (within the meaning of section 898(c)(1)) ending after such date.

3. Modifications of foreign tax credit rules applicable to certain taxpayers receiving specific economic benefits

Present Law

To be a tax eligible for the foreign tax credit, a foreign levy must require a compulsory payment pursuant to the authority of a foreign country to levy taxes.[55] Neither a penalty, fine, interest, nor customs duty is a tax.

In certain cases, foreign countries may seek to charge a foreign company a fee or a royalty for a specific economic benefit bestowed on the company. Instead of doing so directly, however, the foreign country may try to disguise the charge as a tax, knowing that in many cases the foreign company (a "dual capacity" taxpayer)[56] may receive a foreign tax credit from its home country. A foreign country may do so by applying a higher rate or a different base with respect to certain taxpayers or activities. If a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and requires such compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: a tax and a requirement of compulsory payment in exchange for such specific economic benefit.[57]

In general, no foreign tax credit is allowable with respect to a foreign levy paid by a dual capacity taxpayer unless the taxpayer establishes, based on all the relevant facts and circumstances, that an amount paid is pursuant to the distinct element of the levy that is a tax.[58] Instead of the facts-and-circumstances method, however, a taxpayer may elect with respect to a foreign country a safe-harbor method, which determines by formula the distinct element of a foreign levy that is a tax.[59]

In general, the safe-harbor method yields an amount that is approximately equal to the amount the dual capacity taxpayer would pay under the generally applicable foreign income tax

[55] Sec. 901; Treas. Reg. sec. 1.901-2(a)(2)(i).

[56] Treas. Reg. sec. 1.901-2(a)(2)(ii)(A).

[57] Treas. Reg. sec. 1.901-2(a)(2)(i) and (ii)(B) (defining "specific economic benefit").

[58] Treas. Reg. sec. 1.901-2(a)(2)(i) and -2A(b) (describing the burden of proof for dual capacity taxpayers).

[59] Treas. Reg. sec. 1.901-2A(c)(3), (d), and (e).

(if the taxpayer were not a dual capacity taxpayer), with any additional amounts paid pursuant to the foreign levy allowed as a deduction.[60] If the foreign country has no generally applicable income tax, however, then the safe-harbor method uses the U.S. corporate rate (if less than the rate of the foreign levy).[61]

Description of Proposal

The proposal generally codifies the regulatory safe-harbor method. With respect to a foreign levy of a country with no generally applicable income tax, no amount paid by a dual capacity taxpayer is allowable for purposes of the foreign tax credit.

In general, any amount paid or accrued by a dual capacity taxpayer to a foreign country or possession of the United States for any period is not considered a tax (A) if, for the period, such foreign country or possession does not impose a generally applicable income tax or (B) to the extent such amount exceeds the amount which would be paid or accrued by the dual capacity taxpayer under the generally applicable income tax imposed by such country or possession if the taxpayer were not a dual capacity taxpayer.

Nothing in the preceding paragraph is to be construed to imply the proper treatment of any amount not in excess of the amount determined under (B) above.

A dual capacity taxpayer, with respect to any foreign country or possession of the United States, is a person who is subject to a levy of such country or possession and receives (or will receive) directly or indirectly a specific economic benefit from the country or possession.

A generally applicable income tax is an income tax (or a series of income taxes) of a foreign country or possession of the United States which is generally imposed on citizens or residents that are not dual capacity taxpayers.

Effective Date

The proposal applies taxable years of foreign corporations beginning after December 31, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

4. Modifications to foreign tax credit limitations

Present Law

Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed a credit for foreign income taxes they pay directly. In addition, a domestic corporation is allowed a credit for foreign income taxes paid by a CFC with respect to

[60] Treas. Reg. sec. 1.901-2A(e)(1).

[61] Treas. Reg. sec. 1.901-2A(e)(5).

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.[62]

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.[63] 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 or carry forward to one of the succeeding 10 years.[64] No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Deemed paid taxes

For any subpart F income included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to the aggregate foreign income taxes paid or accrued with respect to such income by the CFC.

For any GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to 80 percent of the corporation's inclusion percentage multiplied by the aggregate foreign income taxes paid or accrued with respect to tested income (but not tested loss) by each CFC with respect to which the domestic corporation is a U.S. shareholder.[65]

Allocation and apportionment of deductions

To determine its foreign tax credit limitation, a taxpayer must first determine its taxable income from foreign sources by allocating and apportioning deductions between U.S.-source gross income and foreign-source gross income in each limitation category. In general, deductions are allocated and apportioned to the gross income to which the deductions "definitely related."[66] In other words, allocations and apportionments are made based on the factual relationship of deductions to gross income. If a deduction is not definitely related to any gross income, the deduction must be apportioned ratably. Thus, subject to certain exceptions,

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[62] Secs. 901 and 960; see also secs. 1291(g) and 1293(f) (providing, in the PFIC context, coordination with foreign tax credit rules).

[63] Secs. 901 and 904.

[64] Sec. 904(c).

[65] Sec. 960(d)(1). The inclusion percentage means, with respect to any domestic corporation, the ratio of such corporation's GILTI divided by the aggregate amount of its pro rata share of the tested income (but not tested loss) of each CFC with respect to which it is a U.S. shareholder. Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

[66] Treas. Reg. sec. 1.861-8(b) and (c) and Temp. Treas. Reg. sec. 1.861-8T(c).

deductions for interest expense, stewardship expenses, and research and experimental expenses are apportioned based on certain ratios.[67] For example, interest expense is apportioned based on the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets.[68]

Certain other special rules also apply for purposes of determining a taxpayer's foreign tax credit limitation. For example, in the context of a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation, such taxpayer must determine its foreign-source taxable income (and entire taxable income) by disregarding any dividend for which a dividends-received deduction under section 245A is taken, and any deductions properly allocable or apportioned to income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such foreign corporation, or the stock to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a).[69]

Limitation categories ("baskets")

The foreign tax credit limitation is applied separately to any amount includible in gross income under section 951A (GILTI), foreign branch income,[70] passive category income, and general category income.[71] For this purpose, GILTI and foreign branch income include only income that is not passive category income. Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income.[72] All other income is in the general category. Passive income is treated as general category income if earned by a qualifying financial services entity or if highly taxed (*i.e.*, if the foreign tax rate is determined to exceed the highest tax rate specified in section 1 or 11, as applicable).[73] Dividends (and subpart F inclusions), interest, rents, and royalties received by a U.S. shareholder from a CFC are assigned to the passive category to the extent the payments or inclusions are allocable to passive category income of the CFC.[74] Dividends received by a 10-percent

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[67] Treas. Reg. sec. 1.861-8 through Temp. Treas. Reg. sec. 1.861-14T and Treas. Reg. sec. 1.861-17 set forth detailed rules relating to the allocation and apportionment of expenses.

[68] Sec. 864(e)(2).

[69] Sec. 904(b)(4).

[70] Foreign branch income is defined for this purpose as "the business profits of [the U.S. taxpayer] which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries. For purposes of the preceding sentence, the amount of business profits attributable to a qualified business unit shall be determined under rules established by the Secretary." Sec. 904(d)(2)(J)(i).

[71] Sec. 904(d); Treas. Reg. sec. 1.904-4(a). The foreign tax credit limitation is also applied separately to certain additional separate categories. See Treas. Reg. sec. 1.904-4(m).

[72] Sec. 904(d)(2)(A)(i) and (B).

[73] Sec. 904(d)(2)(B).

[74] Sec. 904(d)(3).

corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[75]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[76] Foreign losses from one category first offset foreign-source income from other categories. Any remaining overall foreign loss offsets U.S.-source income. The same principle applies to losses from U.S. sources. In subsequent years, any losses deducted against another category or source of income are recaptured. That is, an equal amount of income from the same category or source that generated a loss in a prior year is recharacterized as income from the other category or source against which the loss was deducted. Foreign-source income in a particular category may be fully recharacterized as income in another category, whereas only up to 50 percent of income from one source in any subsequent year may be recharacterized as income from the other source.

A taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[77]

Other special rules

Foreign oil and gas taxes

Special rules set forth in section 907 apply with respect to foreign oil and gas taxes paid or accrued during a taxable year. In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on foreign oil and gas taxes.[78] Under this special limitation, amounts claimed as taxes paid on the amount of combined foreign oil and gas income are creditable in a given taxable year (if they otherwise so qualify) only to the extent that the amount of such taxes do not exceed the product of the highest U.S. tax rate on corporations (in the case of corporations) multiplied by such combined foreign oil and gas income for such taxable year. The amount of any such taxes paid or accrued (or deemed paid) in any taxable year in excess of the special limitation (*i.e.*, excess foreign taxes) may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited, but not deducted, to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year.[79]

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[75] Sec. 904(d)(4).

[76] Sec. 904(f) and (g).

[77] Sec. 909.

[78] Sec. 907(a).

[79] Sec. 907(f)(1).

Section 338 and foreign tax credits

Section 338(a) permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale, and the target corporation recognizes gain or loss on the deemed asset sale. The target corporation generally has a fair market value basis in its assets following the transaction.

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(h)(16) generally provides that section 338 does not apply for purposes of determining the source or character of any item for purposes of the foreign tax credit rules in sections 901 through 909. Section 338(h)(16), however, only applies to certain qualified stock purchases of a target corporation and not to transactions that produce results similar to a qualified stock purchase for which a section 338 election is made.

Foreign tax redeterminations

Taxpayers are entitled to either deduct or claim a credit with respect to foreign income taxes. If such taxes are redetermined, taxpayers may change such election on a timely claim for refund or amended return.[80] Foreign taxes are deductible in the year in which the all-events test is met,[81] while credits relate back to the date actually paid. A special exception to the limitations period for claiming refunds extends the period for filing a claim arising from foreign tax credits "actually paid or accrued" to ten years after the filing of the return for the taxable year, but not for claims arising from claims for deductions of foreign taxes.[82] There is no analogous special exception with respect to a change in a foreign tax credit in the statute of limitations for

[80] Secs. 164 (authorizing a deduction for creditable foreign income taxes) and 275(a)(4) (providing no deduction permitted for taxes with respect to which a credit is claimed under section 901).

[81] *Dixie Pine Products Company v. Commissioner*, 320 U.S. 516 (1944) (holding that an accrual-basis taxpayer could not simultaneously contest a liability and claim a deduction for unpaid taxes).

[82] Sec. 6511(d)(3); see also *Trusted Media Brands v. United States*, 899 F. 3d 175 (2d Cir. 2018). The general rule in section 6511(a) requires that claims be filed within a three-year period following the due date (or actual filing date if later) of the original return. Additional special rules are provided for claiming refunds arising from adjustments to other business credits or net operating losses. Section 6511(b) further limits refunds to taxes paid within the two years preceding the claim.

assessment of additional tax.[83] Instead, taxpayers are required to notify the IRS of adjustments to foreign taxes for which a credit or deduction was claimed. Such adjustments include instances in which accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, or any tax paid is refunded in whole or in part. The Secretary is then required to redetermine the amount of the tax for the year or years affected.[84] The interaction of the limitations on changes to foreign tax credit claims, special rules for net operating losses and other business credits is presently under reconsideration by the Secretary.[85]

Description of Proposal

Country-by-country application of section 904 foreign tax credit limitations

In general

The proposal applies the foreign tax credit limitation rules, including the rules relating to foreign oil and gas taxes and deemed paid credits, on a country-by-country basis, thereby preventing taxpayers from using excess foreign taxes paid to high-tax countries to reduce their U.S. tax liability on income earned in low-tax countries. The proposal provides that such provisions each be applied separately with respect to each country[86] by taking into account the aggregate income properly attributable or otherwise allocable to a taxable unit[87] of the taxpayer that is a tax resident of such country. For these purposes, each item is attributable or otherwise allocable to one, and only one, taxable unit of the taxpayer.[88]

The proposal identifies the taxable units of a taxpayer as (i) each CFC with respect to which the taxpayer is a U.S. shareholder; (ii) each interest held (directly or indirectly) by the taxpayer, or any CFC with respect to which the taxpayer is a U.S. shareholder, in a pass-through

[83] See section 6501 generally. In contrast, special provisions therein permit additional periods for assessment of deficiencies resulting from net operating loss or capital loss carrybacks (section 6501(h)) or changes in elections of and deficiencies attributable to certain credits (section 6501(m)).

[84] Sec. 905(c)(1).

[85] Rev. Rul. 2020-08, in which Rev. Rul. 71-533 is suspended and Rev. Rul. 68-150 is suspended in part.

[86] For these purposes, any fiscally autonomous jurisdiction and each possession of the United States is treated as a separate country. For this purpose, possession of the United States means American Samoa, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, Guam, and the Virgin Islands.

[87] The taxable unit standard is intended to serve as a proxy for determining the type of entity or level of activities subject to tax under the tax law of a particular foreign jurisdiction, whether that be as a result of tax residence or a taxable presence.

[88] Further guidance may be necessary to address situations in which the same item of income may be attributable to more than one taxable unit in a tier of taxable units. This may occur, for example, in situations in which a CFC operates a branch in a country other than the country in which the CFC is a tax resident and income earned by the branch is reflected on the books of both the CFC and the branch. Such item is expected to be treated for these purposes as properly attributable to the branch (*i.e.*, the lowest tier).

entity[89] if such pass-through entity is a tax resident of a country other than the country with respect to which such taxpayer or CFC (as the case may be) is a tax resident; (iii) each branch[90] (or portion thereof) the activities of which are directly or indirectly carried on by the taxpayer, or any CFC with respect to which the taxpayer is a U.S. shareholder, and which give rise to a taxable presence in a country other than the country in which the taxpayer or any such CFC (as the case may be) is a tax resident; and (iv) the person that is the taxpayer and not otherwise described in (i), (ii), or (iii).[91] For these purposes, tax resident means a person or arrangement subject to tax under the tax law of a country as a resident, or a person or arrangement that gives rise to a taxable presence by reason of its activities in such country. If an entity is organized under the law of a country or resident in a country that does not impose an income tax with respect to such entity, such entity is treated as subject to tax under the laws of such country.

The proposal provides the Secretary with the authority to issue regulations or other guidance as may be necessary or appropriate to carry out, or prevent avoidance of, the purposes of the proposal, including regulations or other guidance (i) providing for the application of proposal to entities, arrangements, and branches that are otherwise considered a resident of more than one country or no country; (ii) providing for the application of the proposal to hybrid entities or hybrid transactions (as such terms are used for purposes of section 267A), pass-through entities, passive foreign investment companies, trusts and other entities or arrangements not otherwise described in this subsection; and (iii) providing for the assignment of any item (including foreign income taxes and deductions) to taxable units, including in the case of amounts not otherwise taken into account in determining taxable income.

Application of recapture of overall foreign loss

The proposal applies the separate limitation loss rules on a country-by-country basis, modifying the definition of income category to mean each separate category of income described for purposes of the foreign tax credit limitation applied separately with respect to each relevant country in which the taxpayer has a taxable unit.

Application of separate limitation losses with respect to GILTI

The proposal provides a special separate limitation loss rule with respect to income in the GILTI foreign tax credit limitation category. Pursuant to the proposal, the amount of the separate limitation losses for any taxable year reduce income in the GILTI basket for such year

[89] A pass-through entity includes any partnership or other entity or arrangement to the extent that income, gain, deduction, or loss of the entity or arrangement is taken into account in determining the income or loss of a person that owns (directly or indirectly) an interest in such entity or arrangement.

[90] A branch is defined as a taxable presence of a tax resident in a country other than its country of residence as determined under such other country's tax law or as otherwise provided by the Secretary to activities in a country that does not subject income to tax on the basis of residence or taxable presence.

[91] Therefore, the general taxable unit is similar to a residual taxable unit, one that is a tax resident of a country not otherwise described in the other clauses. For example, foreign source royalty income earned, and corresponding withholding tax incurred on such income, by the U.S. taxpayer from intangible property held in the United States is properly attributable to this general taxable unit.

only to the extent the aggregate amount of such losses exceeds the aggregate amount of the separate limitation incomes (not including income in the GILTI basket) for such taxable year.

Repeal of separate application to foreign branch income

The proposal repeals the foreign branch income basket, thereby reducing the number of foreign tax credit limitation categories from four to three. Several conforming amendments are made to account for the elimination of the concept of foreign branch income, including coordination with the deduction for foreign-derived intangible income. The Secretary is granted the authority to prescribe transition rules relating to the carry forward of excess taxes attributable to foreign branch income from a taxable year before its repeal.

Modification of foreign tax credit carryback and carryforward

The proposal repeals the carry back of excess taxes paid or accrued to foreign countries or possessions of the United States for any taxable year and limits the carry forward of such excess foreign taxes to any of the first five succeeding taxable years. A similar change is made with respect to excess foreign oil and gas taxes paid or accrued during any taxable year subject to the special limitation provision relating to such taxes. A conforming amendment is made to section 6511(d)(3) with respect to the special period of limitation on a credit or refund claim relating to an overpayment attributable to foreign taxes paid or accrued. The proposal also extends application of the foreign tax credit carry forward rules to excess foreign taxes in the section 951A foreign tax credit limitation category.

Treatment of certain tax-exempt dividends

The proposal repeals the provision requiring that, for purposes of the foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must determine its foreign-source taxable income (and entire taxable income) by disregarding any dividend for which a dividends-received deduction under section 245A is taken, and any deductions properly allocable or apportioned to income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such foreign corporation, or the stock to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a).

Rules for allocation of certain deductions to certain foreign source income

Under the proposal, for purposes of determining a domestic corporation's foreign tax credit limitation with respect to GILTI, such taxpayer's taxable income from sources without the United States is determined by allocating any deduction allowed under section 250 to such income and by treating any expense of such domestic corporation as not allocable to such income. In other words, under the proposal, deductions for interest expense, stewardship expenses, and research and experimental expenses do not affect the taxpayer's foreign tax credit limitation with respect to GILTI.

Treatment of certain asset dispositions

The proposal extends the principles of section 338(h)(16) to transactions that produce results similar to a qualified stock purchase for which a section 338 election is made, which may include a sale of an interest in an entity that is treated as a corporation for foreign tax purposes but as a partnership or a disregarded entity for U.S. tax purposes, or a taxable change in the classification of an entity for U.S. tax purposes that is not recognized for foreign tax purposes. Pursuant to the proposal, the principles of section 338(h)(16) apply in determining the source and character of any item recognized in connection with a "covered asset disposition" for purposes of applying the foreign tax credit rules. A covered asset disposition means any transaction which is treated as a disposition of assets for U.S. tax purposes but is treated as a disposition of stock of a corporation (or is disregarded) for purposes of the tax laws of the relevant foreign country or possession of the United States. The proposal also grants authority to the Secretary to issue regulations or other guidance as may be necessary or appropriate to carry out, or prevent the avoidance of, the purposes of the proposal.

Redetermination of foreign taxes and related claims

The proposal establishes the period in which elections to either claim a credit or a deduction with respect to foreign taxes under section 901. Absent a consent to extend the time within which an assessment may be made by the IRS with respect to a taxable year, the election to claim a credit is limited by the special limitations period for refunds, and the time to elect to deduct foreign taxes is limited by the general period for seeking a refund. In addition, such changes to the election to claim a credit or deduct foreign taxes, as well as any change in the amount or treatment of foreign taxes which affect a taxpayer's U.S. tax liability, are added to the list of adjustments within the scope of section 905(c) authorizing the IRS to redetermine taxes. The scope and effect of these additions are intended to parallel proposed regulatory changes.[92] For this purpose, changes in treatment of foreign taxes may include changes that are not the result of determinations by a foreign jurisdiction, such as voluntary elections or changes to elections that result in inconsistent treatment. Finally, the proposal clarifies that special limitations period for filing a claim for refund with respect to foreign tax credits is limited to refunds arising by reason of changes in the foreign tax liability and is shortened to from ten to five years.

Effective Date

The proposal generally is effective for taxable years beginning after December 31, 2021, except that with respect to the modifications to the foreign tax credit carryback and carryforward, the proposal applies to taxes paid or accrued in taxable years beginning after December 31, 2021, and with respect to the modifications relating to the redetermination of foreign taxes, the proposal is effective 60 days after the date of enactment.

[92] Prop. Treas. Reg. sec. 1.905-3(c), REG-101657-20, 85 Fed. R. 72028 (November 12, 2020).

5. Foreign oil and gas extraction income and foreign oil related income to include income with respect to minerals from oil shale and tar sands

Present Law

Special foreign tax credit limitation for foreign oil and gas taxes

For purposes of calculating the foreign tax credit allowable, a special limitation applies to certain foreign taxes related to foreign oil and gas income.[93] In general, for a corporation applying the foreign tax credit limitation, the amount of any foreign oil and gas taxes paid or accrued (or deemed to have been paid) during the taxable year that is limited to the amount of the taxpayer's combined foreign oil and gas income for the taxable year multiplied by the corporate tax rate (*i.e.*, 21 percent).

Combined foreign oil and gas income with respect to any taxable year is the sum of foreign oil and gas extraction income ("FOGEI") and foreign oil related income ("FORI").[94] Foreign oil and gas taxes generally are any income taxes paid or accrued (or deemed paid or accrued) during the taxable year with respect to FOGEI or FORI.[95]

FOGEI includes taxable income derived from sources without the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells.[96] FORI includes taxable income derived from sources outside the United States and its possessions from (A) the processing of minerals extracted (by the taxpayer or by any other person) from oil or gas wells into their primary products, (B) the transportation of such minerals or primary products, and (C) the distribution or sale of such minerals or primary products.[97]

Exclusion of FOGEI and inclusion of FORI under GILTI

In general, FORI is tested income for purposes of GILTI.[98] FOGEI, however, is expressly excluded from tested income.[99]

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[93] Sec. 907(a).

[94] Sec. 907(b)(1).

[95] Sec. 907(b)(2) and (c)(5).

[96] Sec. 907(c)(1).

[97] Sec. 907(c)(2).

[98] Sec. 951A(c).

[99] Sec. 951A(c)(2)(A)(i)(V). Section 138126(e) of the bill repeals this exclusion.

Description of Proposal

The proposal amends the definitions of FOGEI and FORI, such that oil and gas wells include oil shale and tar sands.

Effective Date

The proposal applies to taxable years of foreign corporations beginning after December 31, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

6. Modifications to inclusion of global intangible low-taxed income

Present Law

Global intangible low-taxed income

A U.S. shareholder of a controlled foreign corporation ("CFC")[100] must include in gross income its GILTI.[101] GILTI is the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.[102] The shareholder's net deemed tangible income return equals the excess of 10 percent of the aggregate of its *pro rata* share of the qualified business asset investment ("QBAI") of each CFC over certain interest expense.[103]

The formula for GILTI is:

$$GILTI = Net\ CFC\ Tested\ Income - [(10\% \times QBAI) - Interest\ Expense]$$

[100] U.S. shareholders are U.S. persons that own at least 10 percent (measured by vote or value) of the stock of a foreign corporation. A CFC generally is any foreign corporation in which U.S. shareholders own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value). See secs. 951(b), 957, and 958.

[101] See also sec. 951A(f)(1) (treating any GILTI inclusion in the same manner as subpart F income under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4)) and (2) (providing rules relating to the allocation of GILTI inclusions to CFCs).

[102] Sec. 951A(b)(1).

[103] The interest expense that reduces a U.S. shareholder's net deemed tangible income return is that which is taken into account in determining its net CFC tested income for the taxable year to the extent that the interest income attributable to such interest expense is not taken into account in determining the shareholder's net CFC tested income. Sec. 951A(b)(2)(B).

Net CFC tested income

Net CFC tested income means the excess of the aggregate of the shareholder's *pro rata* share of the tested income of each CFC over the aggregate of its *pro rata* share of the tested loss of each CFC.[104] In other words, GILTI is calculated on a worldwide basis.

The tested income of a CFC is the excess of the gross income of the CFC determined without regard to certain amounts that are excluded from tested income (referred to in this document as "gross tested income") over deductions (including taxes) properly allocable to such gross tested income.[105] The exclusions from gross tested income are: (1) any effectively connected income described in section 952(b); (2) any gross income taken into account in determining the CFC's subpart F income;[106] (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4);[107] (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in section 907(c)(1)).[108]

The tested loss of a CFC means the excess of deductions (including taxes) properly allocable to the CFC's gross tested income over the amount of such gross tested income.[109]

Qualified business asset investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of the CFC's adjusted bases in specified tangible property that is both used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.[110]

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[104] Sec. 951A(c)(1). *Pro rata* shares are determined under subpart F principles (*i.e.*, the rules of section 951(a)(2) and the regulations thereunder). See sec. 951A(e).

[105] Sec. 951A(c)(2)(A).

[106] Earnings of a CFC may constitute income to U.S. shareholders under the traditional anti-deferral regime of subpart F of the Code, which applies to certain passive income and certain other related-party income that is readily movable from one jurisdiction to another. Subpart F income is taxed at full rates with related foreign income taxes generally eligible for the foreign tax credit.

[107] In general, subpart F income excludes any item of income if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (currently 21 percent). See sec. 954(b)(4).

[108] Section 951A does not, however, exclude from gross tested income any foreign oil related income (as defined in section 907(c)(2)).

[109] Sec. 951A(c)(2)(B).

[110] Sec. 951A(d)(1).

Specified tangible property means any tangible property used in the production of tested income.[111] In the case of property used both in the production of tested income and income which is not tested income, such property shall be treated as specified tangible property in the same proportion that the gross tested income produced with respect to such property bears to the total gross income produced with respect to such property.

Description of Proposal

Country-by-country application of section 951A based on CFC taxable units

The proposal applies section 951A on a country-by-country basis, incorporating a CFC taxable unit concept (based on the taxable unit standard adopted for purposes of applying the foreign tax credit limitation provisions) as the mechanism for identifying each relevant country with respect to which a CFC is subject to tax or in which a CFC has a taxable presence. For these purposes, the term "CFC taxable unit" means, with respect to any CFC with respect to which the taxpayer is a U.S. shareholder, (i) the controlled foreign corporation itself, (ii) each interest held (directly or indirectly) by the CFC in a pass-through entity[112] if such pass-through entity is a tax resident of a country other than the country with respect to which such CFC is a tax resident; and (iii) each branch[113] (or portion thereof) the activities of which are directly or indirectly carried on by the CFC and which give rise to a taxable presence in a country other than the country in which such CFC is a tax resident. The terms used for purposes of applying section 951A on a country-by-country basis have the same meaning when used for purposes of applying the foreign tax credit limitation rules on a country-by-country basis (*e.g.*, tax resident[114]).[115]

The proposal provides that if a CFC taxable unit of a U.S. shareholder is a tax resident of a country that is different from the country with respect to which at least one other CFC taxable unit of such U.S. shareholder is a tax resident, then such shareholder's GILTI equals the sum of

[111] Sec. 951A(d)(2). Specified tangible property does not include property used in the production of tested loss; thus, a CFC with a tested loss in a taxable year does not have QBAI for such taxable year.

[112] A pass-through entity includes any partnership or other entity or arrangement to the extent that income, gain, deduction, or loss of the entity or arrangement is taken into account in determining the income or loss of a person that owns (directly or indirectly) an interest in such entity or arrangement.

[113] A branch is defined as a taxable presence of a tax resident in a country other than its country of residence as determined under such other country's tax law or as otherwise provided by the Secretary to activities in a country that does not subject income to tax on the basis of residence or taxable presence.

[114] For these purposes, tax resident means a person or arrangement subject to tax under the tax law of a country as a resident, or a person or arrangement that gives rise to a taxable presence by reason of its activities in such country. If an entity is organized under the law of a country, or resident in a country, that does not impose an income tax with respect to such entity, such entity is treated as subject to tax under the tax law of such country. In addition, any fiscally autonomous jurisdiction and each possession of the United States is treated as a separate country. For this purpose, possession of the United States means American Samoa, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, Guam, and the Virgin Islands.

[115] See section 138124 of the bill for a description of the provision applying the foreign tax credit limitation rules on a country-by-country basis.

the amounts of GILTI determined separately with respect to each country with respect to which any CFC taxable unit of such shareholder is a tax resident. For purposes of determining such separate amounts, the proposal applies section 951A(b), (c), and (d) on a country-by-country basis by treating any reference in those provisions to a CFC of such shareholder to a CFC taxable unit of such shareholder. In addition, the proposal provides that net CFC tested income, net deemed tangible income return, QBAI, interest expense described in section 951A(b)(2)(B), and such other items and amounts as the Secretary may provide, must be determined separately with respect to each such country by determining such amounts with respect to each CFC taxable unit of such shareholder which is a tax resident of such country. Rules similar to those applicable for purposes of applying the foreign tax credit limitation provisions on a country-by-country basis also apply for purposes of applying section 951A on a country-by-country basis.

The proposal also provides that, except as otherwise provided by the Secretary, the rules relating to the allocation of GILTI to CFCs set forth in section 951A(f)(2) must be applied separately with respect to each CFC taxable unit.

The proposal moves the grant of regulatory authority under section 951A(d)(4) to new section 951A(g) to clarify that such authority is not limited to section 951A(d). The proposal expands that grant of authority to account for the country-by-country application of section 951A based on CFC taxable units.

Carryover of net CFC tested loss

The proposal provides that, if, after determining the net CFC tested income of a U.S. shareholder in a particular country for any taxable year, such U.S. shareholder has a net CFC tested loss, such net CFC tested loss of the U.S. shareholder carries over to, and is treated as a tested loss in, the next succeeding taxable year with respect to such country. Proper adjustments must be made in allocating the total amount of GILTI included by such U.S. shareholder to take into account any decrease in GILTI by reason of the net CFC tested loss carryover. The proposal also provides for coordination with the country-by-country application of section 951A.

Reduction in net deemed tangible income return for purposes of determining GILTI

The proposal generally reduces the deemed rate of return on the aggregate of a U.S. shareholder's pro rata share of the QBAI of each of its CFC taxable units in a country from 10 percent to five percent for purposes of determining the U.S. shareholder's net deemed tangible income return. A special rule applies to specified tangible properly located in a possession of the United States, which retains the 10 percent deemed rate of return on the aggregate amount of such property in such possession.

Inclusion of foreign oil and gas extraction income in determining tested income and loss

The proposal repeals the exclusion from gross tested income for foreign oil and gas extraction income (as defined in section 907(c)(1)). As a result, foreign oil and gas extraction income must be taken into account in determining tested income and tested loss.

Coordination with other provisions

The proposal clarifies that references to section 951 or section 951(a) in sections 959, 961, 962, and such other sections as the Secretary may identify shall include references to section 951A or 951A(a), respectively.

Effective Date

The proposal generally applies to taxable years of foreign corporations beginning after December 31, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. The proposal clarifying the coordination of section 951A with other provisions applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

7. Modifications to determination of deemed paid credit for taxes properly attributable to tested income

Present Law

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.[116]

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.[117] 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 or carry forward to one of the succeeding 10 years.[118] No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

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[116] Secs. 901 and 960; see also secs. 1291(g) and 1293(f) (providing, in the PFIC context, coordination with foreign tax credit rules).

[117] Secs. 901 and 904.

[118] Sec. 904(c).

Deemed-paid taxes

For any subpart F income included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to the aggregate foreign income taxes paid or accrued with respect to such income by the CFC.

For any GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to 80 percent (the "20-percent haircut") of the corporation's inclusion percentage multiplied by the aggregate foreign income taxes paid or accrued with respect to tested income (but not tested loss) by each CFC with respect to which the domestic corporation is a U.S. shareholder.[119]

The inclusion percentage means, with respect to any domestic corporation, the ratio of such corporation's GILTI divided by the aggregate amount of its pro rata share of the tested income (but not tested loss) of each CFC with respect to which it is a U.S. shareholder. Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).[120]

Description of Proposal

The proposal replaces, in section 960(d)(1), "80 percent" with "95 percent (100 percent in the case of tested foreign income taxes paid or accrued to a possession of the United States)." In other words, the proposal generally replaces the 20-percent haircut with a five-percent haircut.

The proposal expands the definition of tested foreign income taxes to include foreign income taxes that are properly attributable to amounts taken into account in determining tested income or tested loss under section 951A.

In addition, the proposal grants the Secretary the authority to expand the definition of tested foreign income taxes to include foreign income taxes paid or accrued by a foreign corporation (other than such CFC) which owns, directly or indirectly, 80 percent or more (by vote or value) of the stock in such domestic corporation but only if (i) such foreign income taxes are properly attributable to amounts of such controlled foreign corporation taken into account in determining tested income or tested loss under section 951A and (ii) no credit is allowed, in whole or in part, for such foreign taxes in any foreign jurisdiction.

Effective Date

The proposal applies to taxable years of foreign corporations beginning after December 31, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

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[119] Sec. 960(d)(1).

[120] Sec. 960(d)(3).

8. Deduction for foreign-source portion of dividends limited to CFCs

Present Law

In the case of any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a U.S. shareholder with respect to the foreign corporation, a deduction is allowed equal to the foreign-source portion of the dividend.[121]

In general, a specified 10-percent owned foreign corporation is any foreign corporation with respect to which any domestic corporation is a U.S. shareholder.[122]

For purposes of determining when a person is a U.S. shareholder, section 958 applies the constructive ownership rules of section 318(a), with a few modifications. Section 318(a)(3) provides rules for when a corporation, partnership, trust, or estate is considered to own stock owned by a shareholder, partner, or beneficiary (so-called "downward attribution"). For example, under section 318(a)(3)(C), a corporation is considered as owning stock owned, directly or indirectly, by or for any shareholder that owns 50 percent or more of the corporation. Before the repeal of section 958(b)(4), stock owned by a foreign person was not attributed downward to a U.S. person.[123] As a result, a wholly owned domestic subsidiary of a foreign corporation was not treated as owning stock in other foreign corporations owned by the foreign parent. Since the repeal of section 958(b)(4), attribution of certain stock of a foreign corporation owned by a foreign person to a related U.S. person is required for purposes of determining whether the U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC.

Description of Proposal

First, the proposal limits the deduction under section 245A to dividends received from a CFC.

Second, the proposal allows all U.S. shareholders of a foreign corporation which is not a CFC to elect, along with the foreign corporation, to treat the foreign corporation as a CFC (but not for purposes of new section 951B (described below) or for any other purpose determined by the Secretary). The election is binding on the current U.S. shareholders and all future U.S. shareholders of the foreign corporation. The election is revocable only with consent of the Secretary.

Third, the proposal restores former section 958(b)(4).

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[121] Sec. 245A(a). The foreign-source portion of any dividend equals the amount of the dividend multiplied by the percentage of undistributed earnings that are attributable neither to ECI nor to certain dividends received from domestic corporations. Sec. 245A(c).

[122] Sec. 245A(b)(1). U.S. shareholders are U.S. persons that own at least 10 percent of the stock (measured by vote or value) of a foreign corporation. Sec. 951(b).

[123] See former sec. 958(b)(4) (repealed by sec. 14213 of Pub. L. 115-97).

Fourth, the proposal provides a narrow rule in new section 951B for downward attribution from a foreign person in certain cases. In general, the rules of subpart F apply to a foreign controlled U.S. shareholder ("FCUSS") of a foreign controlled foreign corporation ("FCFC") as if the former were a U.S. shareholder and the latter were a CFC. An FCUSS is a U.S. person that would be a U.S. shareholder with respect to a foreign corporation if (1) to be a U.S. shareholder the U.S. person must own more than 50 percent of the stock of the foreign corporation and (2) downward attribution from foreign persons applies. An FCFC is a foreign corporation, other than a CFC, more than 50 percent of which is owned by FCUSS. Given that a U.S. person is an FCUSS only with respect to a foreign corporation of which the U.S. person owns more than 50 percent, the foreign corporation with respect to which the U.S. person is an FCUSS is always an FCFC.

The proposal grants Treasury regulatory authority to determine when any such U.S. person or foreign corporation should be considered a U.S. shareholder or CFC, respectively, and to prescribe anti-avoidance measures consistent with the intent of the provision.

Effective Date

The proposal generally applies to distributions made after the date of enactment.

With respect to the modifications related to the restoration of former section 958(b)(4) and the enactment of new section 951B, the proposal applies to (A) the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent taxable year of such foreign corporations and (B) taxable years of U.S. persons in which or with which such taxable years of foreign corporations end.

9. Limitation on foreign base company sales and services income

Present Law

Subpart F Income

Under subpart F of the Code, U.S. shareholders of a CFC must include in income their *pro rata* shares of subpart F income, without regard to whether the income is distributed to the shareholders.[124] In effect, U.S. shareholders of a CFC are treated as having received a current distribution of the CFC's subpart F income. With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one jurisdiction to another. Subpart F income consists of foreign base company income,[125] insurance income,[126] and certain income relating to international boycotts and other violations of public policy.[127]

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[124] Sec. 951(a).

[125] Secs. 952(a)(2) and 954.

[126] Secs. 952(a)(1) and 953.

[127] Sec. 952(a)(3)-(5).

Foreign base company income consists of foreign personal holding company income, foreign base company sales income, and foreign base company services income.[128] Foreign personal holding company income includes passive income such as dividends, interest, rents, and royalties. Foreign base company sales income generally includes income derived in connection with (i) the purchase of personal property from a related person and its sale to any person, (ii) the sale of personal property to any person on behalf of a related person, (iii) the purchase of personal property from any person and its sale to a related person, or (iv) the purchase of personal property from any person on behalf of a related person, but only if (1) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and (2) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.[129] In other words, foreign base company sales income includes income derived by a CFC from a purchase or sale of personal property involving a related party in which the goods are both manufactured and sold for use or consumption outside the CFC's country of organization. Foreign base company services income generally includes income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are performed (i) for, or on behalf of, any related person, and (ii) outside the country under the laws of which the controlled foreign corporation is created or organized.[130] For purposes of determining foreign base company sales or services income, a person is a related person with respect to a CFC, if such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the CFC, or such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the CFC.

Insurance income subject to current inclusion under subpart F 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.[131]

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[128] Sec. 954.

[129] See also sec. 954(d)(2) (providing a special rule applicable in situations in which the carrying on of activities by a CFC through a branch or similar establishment outside the country of incorporation of the CFC has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income; in such situations, pursuant to regulations prescribed by the Secretary, the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the CFC and shall constitute foreign base company sales income of the CFC).

[130] See also sec. 954(e)(2) (providing an exception for income derived in connection with the performance of services which are directly related to (i) the sale or exchange by the CFC of property manufactured, produced, grown, or extracted by it and which are performed before the time of the sale or exchange, or (ii) an offer or effort to sell or exchange such property).

[131] Sec. 953(a) and (e).

Investments in U.S. property

U.S. shareholders also must include their *pro rata* shares of a CFC's untaxed earnings invested in certain items of U.S. property.[132] For this purpose, U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[133] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[134]

Exceptions

Subpart F income does not include certain dividends, interest, rents, and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[135] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. A second exception (the "high-tax exception") is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate in effect at the time the income was earned (*e.g.*, for income earned by a CFC in tax year 2021, more than 90 percent of 21 percent, or 18.9 percent).[136] A third exception excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC to the extent attributable or properly allocable to income of the payor that is not subpart F income.[137]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[138] 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, and other requirements must be met.

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[132] Secs. 951(a)(1)(B) and 956.

[133] Sec. 956(c)(1).

[134] Sec. 956(c)(2).

[135] Sec. 954(c)(3).

[136] Sec. 954(b)(4). This exception applies to an item of income that would otherwise be included in foreign base company income or insurance income within the meaning of sections 954(a) and 953, respectively.

[137] Sec. 954(c)(6). CFC look-through applies to taxable years of foreign corporations beginning before January 1, 2026, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[138] Sec. 954(h).

For a securities dealer, foreign personal holding company income excludes any interest or dividend (or certain equivalent amounts) from any transaction entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475.[139]

Exclusion of previously taxed earnings and profits

A U.S. shareholder may exclude from its income actual distributions of earnings and profits from a CFC that were previously included in income by the U.S. shareholder under subpart F.[140] Any income inclusion resulting from an investment in U.S. property also may be excluded when such earnings and profits are ultimately distributed.[141]

Basis adjustments

A U.S. shareholder of a CFC generally increases the basis in its CFC stock by the amount of subpart F income inclusions and generally reduces the basis in its CFC stock by the amount of any distributions that are excluded from its income as previously taxed earnings and profits.[142]

Description of Proposal

Pursuant to the proposal, foreign base company sales income and foreign base company services income would be limited to situations in which the relevant arrangement (including a single transaction or series of transactions) involves a related person that is a taxable unit (within the meaning of section 904(e)) which is a tax resident of the United States.[143] In other words, arrangements that would otherwise give rise to foreign base company sales or services income, but for the fact that such arrangements do not involve a related U.S. person, are outside the scope of such rules and, instead, subject to section 951A.

In addition, the proposal clarifies that the rules in section 961(c) apply in determining the basis of stock and certain property and the recognition of gain for all purposes of the Code. The proposal further clarifies that gain may be recognized by reason of section 961(b) and (c) upon a distribution of previously taxed earnings and profits by a lower-tier CFC to an upper-tier CFC in situations in which the amount of the distribution exceeds the upper-tier CFC's basis in the stock of the lower-tier CFC.

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[139] Sec. 954(c)(2)(C).

[140] Sec. 959(a)(1).

[141] Secs. 959(a)(2) and 956.

[142] Sec. 961.

[143] The proposal grants authority to the Secretary to issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the proposal, including such regulations or other guidance providing for the proper application of the proposal in situation in which the relevant arrangement (including a single transaction or series of transactions) involves a related U.S. person (or a U.S. taxable unit of a related U.S. person).

Several conforming amendments are included that are integral to the prospective application of the proposal. One amendment allocates section 951(a) items to a U.S. shareholder to the extent such U.S. shareholder received a distribution of current earnings and profits that: (1) would give rise to a deduction under section 245A(a), or (2) in the case of a dividend paid directly or indirectly to a CFC with respect to stock owned by the shareholder within the meaning of section 958(a)(2) (*i.e.*, stock owned through foreign entities), would not result in subpart F income to the CFC by reason of section 954(b)(4), (c)(3), or (c)(6). Consistent with current law, the provision allocates the remaining section 951(a) items to U.S. shareholders in proportion to their ownership on the last day, in the foreign corporation's taxable year, on which the foreign corporation is a CFC. Related amendments are made to section 951A(e)(1) and (2) and to section 953(c)(5)(A). In addition, an amendment clarifies that foreign tax credits taken by reason of withholding tax imposed on a distribution of previously taxed earnings and profits do not result in an additional section 78 gross-up.

Effective Date

The proposal generally applies to taxable years of foreign corporations beginning after December 31, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

The technical amendments made with respect to the pro rata share rules apply to distributions made after December 31, 2017, and the technical amendment made with respect to the section 78 gross-up apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

D. Inbound International Provisions

1. Modifications to base erosion and anti-abuse tax

Present Law

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.[144]

The BEAT applies only to corporate taxpayers with average gross receipts in excess of $500 million and is determined, in part, by the extent to which a taxpayer has made payments to foreign related parties.[145] 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).

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 a certain tax credits.[146]

Base erosion payments and base erosion benefits

A base erosion tax benefit generally reflects the reduction in taxable income arising from the associated base erosion payment.

A base erosion payment generally is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable.[147] A base erosion payment includes any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).[148]

Base erosion payments generally do not include any amount that constitutes a reduction in gross receipts, including payments for cost of goods sold. Certain other payments are

[144] Sec. 59A.

[145] 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 sections 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.

[146] Sec. 59A(b).

[147] Sec. 59A(d)(1).

[148] Sec. 59A(d)(2).

excluded from the definition of base erosion payment, including certain payments for services[149] and qualified derivative payments.[150] A payment for a service by a U.S. corporation to a foreign related party is a base erosion payment, except to the extent that the services in question included a markup component. In final regulations, the Secretary provided that a portion of costs meeting the standards for use of the "services cost method"[151] may not be treated as base erosion payments. Instead, only the portion of the outbound payment in excess of actual costs incurred by the recipient of the payment, i.e., the markup component of the price charged, is a base erosion payment.[152]

The BEAT treats as a base erosion payment any reinsurance premium payment paid by a U.S. life insurance company or by a U.S. property and casualty insurance company to a related foreign reinsurer (*e.g.*, a U.S. insurer pays a reinsurance premium to a related foreign reinsurer to cover risk of storm damage in the United States).[153] It also may apply to payment by a U.S. reinsurer to a related foreign insurer on the occurrence of a covered event (*e.g.*, if reinsurance recoverable is paid for earthquake damage in a foreign country). However, the BEAT provides no rule of exclusion for receipt by the U.S. insurer of reinsurance recovered (*e.g.*, the related foreign reinsurer pays the U.S. insurer when a claim is made for storm damage in the United States), nor is there a rule of exclusion applicable to the reinsurance premium paid by a foreign insurer to a related U.S. reinsurer (*e.g.*, to cover earthquake risk in a foreign country).

Taxpayers are permitted to waive deductions and thus avoid "base erosion tax benefits" of such deduction to reduce exposure to the BEAT. The Secretary adopted a rule permitting taxpayers to waive the right to deductions for payments otherwise within the scope of base erosion payments.[154] The waiver authority extended to insurance-related payments that were reductions from gross premiums and other consideration.

Calculation of BEAT liability

BEAT liability generally equals the excess, if any, of 10 percent of the taxpayer's modified taxable income over the amount of regular tax liability[155] reduced (but not below zero) by the sum of certain tax credits. The amount of regular tax liability is reduced (and the base erosion minimum tax amount increased) by all income tax credits except for the research

[149] Sec. 59A(d)(5).

[150] Sec. 59A(h).

[151] Treas. Reg. sec. 1.482-9.

[152] Treas. Reg. sec. 1.59A-3(b)(3)(i).

[153] Secs. 59A(d)(3), 803(a)(1)(B) and 832(b)(4)(A).

[154] Treas. Reg. sec. 1.59A-3(c)(6).

[155] As defined in section 26(b).

credit[156] and a certain portion of applicable section 38 credits.[157] Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any base erosion payment and an adjustment for the taxpayer's NOL deduction, if any.[158]

Special rules for taxable years beginning after December 31, 2025

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.[159]

Special rules for banks and securities dealers

An applicable taxpayer that is a member of an affiliated group that includes a bank (as defined in section 581) or securities dealer registered under section 15(a) of the Securities Exchange Act of 1934 is subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate.[160] In addition, 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).[161]

Description of Proposal

The proposal changes the scope for determining which companies are applicable taxpayers. In taxable years beginning after December 31, 2023, applicable taxpayers are no longer limited to those with a three-percent base erosion percentage or higher. As a result, all corporations (other than a regulated investment company, a real estate investment trust, or an S corporation) that meet the gross receipts threshold are applicable taxpayers and potentially subject to the BEAT.

[156] Sec. 41(a).

[157] Sec. 59A(b)(4). Applicable section 38 credits are credits allowed under section 38 for the taxable year that are properly allocable to the low-income housing credit (sec. 42(a)), the renewable energy production credit (sec. 45(a)), and the energy investment credit (sec. 48). In general, no more than 80 percent of the amount of applicable section 38 credits for a taxable year can be used to reduce an applicable taxpayer's base erosion minimum tax liability and in no case can applicable section 38 credits reduce the taxpayer's base erosion minimum tax liability by more than 80 percent. Sec. 59A(b)(1)(B)(i)(II).

[158] An applicable taxpayer's modified taxable income is its taxable income for the taxable year increased by (1) any base erosion tax benefit with respect to any base erosion payment and (2) the base erosion percentage of any NOL deduction allowed under section 172 for such taxable year. Sec. 59A(c)(1).

[159] Sec. 59A(b)(2).

[160] Sec. 59A(b)(3).

[161] Sec. 59A(e)(1)(C).

In addition, the applicable calculations required under the BEAT to target base-eroding activity and undertaxed payments, including modified taxable income, base erosion benefits and payments, as well as the rates of the BEAT tax are changed as described below.

Base erosion tax benefits and base erosion payments

Modified taxable income adds certain indirect costs regarding inventory to the category of base erosion payments and clarifies the treatment of net operating losses in the determination of base erosion benefits. In addition, the proposal expands and clarifies the exceptions from base erosion payments.

Indirect costs of goods sold and base erosion payments

Amounts paid or incurred by the taxpayer to a related foreign party are base erosion payments to the extent that they constitute indirect costs that are required to be included in inventory costs by reason of section 263A. In addition, costs incurred in acquiring property that is inventory in the hands of the taxpayer are treated as base erosion payments to the extent such costs exceed the sum of the direct costs of the property in the hands of the foreign related party and the indirect costs (as described in section 263A(a)(2)(B)) of such foreign related party that are demonstrated to have been paid or incurred by such foreign related party to an unrelated U.S. person. Transactions between two foreign entities related to the taxpayer are subject to similar rules regarding characterization of the payment as an indirect cost within the scope of base erosion payments, unless they were paid or incurred (directly or indirectly) to an unrelated U.S. person.

In lieu of including the indirect costs of a related foreign party in its computation of base erosion payments, a taxpayer may elect to treat as a base erosion payment 20 percent of the amount paid or incurred to such related foreign party for the acquisition of inventory. The items or classes of inventory eligible for such election, as well as the time and manner for making such election are to be determined by the Secretary.

Net operating losses in computing modified taxable income

For taxable years beginning after 2021, the net operating loss for which a deduction is permitted under section 172 is taken into account in determining modified taxable income, but is determined without regard to any deduction which is a base erosion tax benefit. Such determination is made for each taxable year. Appropriate adjustments are made to take into account the percentage limitations applicable to corporations under section 172, as well as the rules therein regarding certain contributions and capital gains property.

Transition rules similar to the tax benefit and coordination rules applicable to the alternative minimum tax computations under section 59(g) and (h) are to be used in determining modified taxable income, including those arising from net operating losses or base erosion tax benefits arising from the new category of base erosion payments and related basis adjustments.

Consolidation and expansion of exceptions from base erosion payments

Payments that are subject to Federal income tax by either the payor or the payee are outside the scope of base erosion payments, without regard to whether the income related to such payments was eligible for a reduced rate of tax. Thus, outbound payments to a related party that are included in the computation of GILTI or FDII (without regard to the section 250 deduction), subject to withholding tax or taxable as effectively connected income to the recipient are not base erosion payments. Whether a payment is subject to Federal income tax is determined using principles similar those in former section 163(j)(5).

In addition, payments that are subject to a sufficient level of foreign income tax are not within the scope of base erosion payments. Payments are subject to sufficient foreign tax if they are subject to an effective tax rate at least equal to the applicable percentage for a taxpayer tax in that taxable year. For this purpose, the effective tax rate is computed in the same manner as under the provisions of 904 and may be based on applicable financial statements. The Secretary is authorized to prescribe rules to prevent tax avoidance, including criteria for recharacterizing a transaction or series of transactions among related parties.

Calculation of BEAT liability

The proposal strikes the provision that required adding general credits back to the regular tax liability before determining the BEAT. The BEAT liability, computed using the applicable percentage, now equals the excess of BEMTA over regular tax liability.

For taxable years beginning after December 31, 2021, and ending before January 1, 2024, the applicable percentage is 10 percent. The applicable percentage is 12.5 percent for taxable years beginning after December 31, 2023, and ending before January 1, 2026. For taxable years beginning after December 31, 2025, the BEAT rate is 15 percent.

The general business credit may be applied to offset BEAT liability.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

E. Other Business Tax Provisions

1. Credit for clinical testing of orphan drugs limited to first use or indication

Present Law

The Code provides a 25-percent business tax credit for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified clinical testing expenses are costs paid or incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (the "FDA") but before the drug has been approved for sale by the FDA.[162] A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug.[163]

Amounts included in computing the credit are excluded from the computation of the research credit.[164]

No deduction is allowed for the portion of otherwise allowable qualified clinical testing expenses equal to the amount of the orphan drug credit allowed for the taxable year.[165]

Description of Proposal

The proposal requires that human clinical testing may be taken into account for purposes of the credit only to the extent that such testing is related to the first use or indication with respect to which a drug for a rare disease or condition is designated under section 526 of the Federal Food, Drug, and Cosmetic Act. Further, the proposal requires that such testing must occur (1) before the first date on which an application (with respect to any use or indication with respect to any disease or condition) with respect to a drug is approved under section 505(c) of the Federal Food, Drug, and Cosmetic Act, or (2) if a drug is a biological product, before the first date on which a license, with respect to any use or indication with respect to any disease or condition) for such drug is issued under section 351(a) of the Public Health Service Act.

Effective Date

The proposal applies to taxable years beginning after December 31, 2021.

[162] Sec. 45C(b).

[163] Sec. 45C(d)(1).

[164] Sec. 45C(c).

[165] Sec. 280C(b).

2. Modifications to treatment of certain losses

Present Law

Section 165(a) and worthlessness

Deductions may be allowed for any loss sustained during the taxable year and not compensated for by insurance or otherwise.[166] For such loss to be allowed as a deduction, the loss must be "evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year."[167] The amount of the deduction is determined by reference to the adjusted tax basis of the property used for "determining the loss from the sale or other disposition of property."[168]

Among the events giving rise to such a loss deduction is worthlessness.[169] The test for worthlessness, which is a facts and circumstances analysis,[170] is two-pronged. A taxpayer must demonstrate (1) the asset in question is objectively valueless ("objective worthlessness") and (2) a subjective determination of worthlessness ("subjective worthlessness").[171]

To show objective worthlessness, the taxpayer must make a reasonable showing that the asset was "in fact valueless at the time selected by the taxpayer."[172] A mere diminution in the asset's value is insufficient to establish worthlessness.[173] Taxpayers normally demonstrate objective worthlessness by showing an "identifiable event."[174]

To satisfy the subjective prong of the test, the taxpayer must reasonably believe that the asset lacks any future value[175] and the taxpayer's actions should reflect the taxpayer's subjective

[166] Sec. 165(a).

[167] Treas. Reg. §1.165-1(b).

[168] Sec. 165(b). Furthermore, for individuals, section 165 deductions are limited to (1) losses incurred in a trade or business, (2) losses incurred in a transaction entered into for profit and (3) except in certain circumstances, losses arising from fire, storm, shipwreck or other casualty, or from theft. Sec.165(c).

[169] See, *e.g.*, Rev. Rul. 2004-58, 2004-24 I.R.B. 1043 (discussing the requirements for a "deduction for worthlessness under §165[a]").

[170] See, *e.g.*, *Boehm v. Comm'r*, 326 U.S. 287 (1945).

[171] *Morton v. Comm'r*, 38 B.T.A. 1270, 1278-79 (1938).

[172] *Echols v. Comm'r*, 935 F.2d 703, 708 (5th Cir. 1991), *rehearing denied*, 950 F.2d 209 (5th Cir. 1991).

[173] *Kraft, Inc. v. U.S.*, 30 Fed. Cl. 739, 785-86 (1994); *Proesel v. Comm'r*, 77 T.C. 992, 1006 (1981).

[174] *Morton v. Comm'r*, 38 B.T.A. 1270 (1938) (nonacq.), *aff'd,* 112 F.2d 320 (7th Cir. 1940).

[175] *Lawson v. Comm'r*, 42 B.T.A. 1103, 1108 (1940).

determination.[176] The judicial standard requires a taxpayer neither to be an "incorrigible optimist"[177] nor a "stygian pessimist."[178]

Worthless partnership interests

Courts have held that a partner may claim a loss with respect to the worthlessness of a partnership interest under section 165(a).[179] Case law and service guidance indicates whether such loss is generally ordinary or capital depends on whether the loss is deemed to result from the sale or exchange of a capital asset.[180] Specifically, the character generally depends on whether the partner claiming such loss has any share of partnership liabilities immediately before the worthlessness claim. This is because a shift in liabilities (in connection with a worthlessness claim or otherwise) causes a deemed distribution under the partnership tax rules[181] and a distribution (deemed or otherwise) is treated as a sale or exchange under the partnership tax rules.[182] Thus, generally, a partner will take an ordinary loss upon the worthlessness of its partnership interest if the partner claiming worthlessness has no share of any partnership liability immediately prior to the claim and a partner will take a capital loss upon the worthlessness of its partnership interest if the partner has a share of any partnership liability immediately prior to the claim.

Worthless securities

Present law provides special rules for worthless securities. If a security that is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange of such capital asset on the last day of the taxable year. For this purpose, securities are defined as (1) a share of stock in a corporation; (2) a right to subscribe for, or to receive, a share of stock in a corporation; or (3) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

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[176] See *e.g., Echols v. Comm'r*, 935 F.2d 703, 707-708 (5th Cir. 1991), *rehearing denied*, 950 F.2d 209 (5th Cir. 1991).

[177] *United States v. S.S. White Dental Manufacturing Co.*, 274 U.S. 398, 403 (1927).

[178] *Ruppert v. U.S.*, 22 F. Supp. 428, 431 (Ct. Cl. 1938), *cert. denied*, 305 U.S. 630 (1938) (worthlessness claim for a bad debt).

[179] See *Echols v. Comm'r*, 935 F.2d 703 (5th Cir. 1991), *rehearing denied*, 950 F.2d 209 (5th Cir. 1991); *Zeeman v. U.S.*, 75 F. Supp. 235 (S.D.N.Y. 1967), *aff'd in part, rev'd in part*, 395 F.2d 861 (2d Cir. 1968); *In Re. Kreidle*, 91-2 U.S.T.C. ¶50,371 (Bankr. D. Col. 1991), *aff'd*, 143 B.R. 941 (D.C. Col. 1992); *Tejon Ranch v. Comm'r*, 49 T.C.M. (CCH) 1357 (1985). See also Rev. Rul. 93-80, 1993-2 C.B. 235.

[180] *La Rue v. Comm'r*, 90 T.C. 465 (1988); Rev. Rul. 93-80, 1993-2 C.B. 235. Section 751's hot assets rules may apply in the case of capital loss.

[181] Sec. 752(b).

[182] Sec. 761(e).

A security is not considered worthless if there is a reasonable hope and expectation of future value. Taxpayers must demonstrate the existence of an identifiable event that clearly indicates the "destruction of both the potential and liquidating values of the stock."[183]

Corporate liquidations

In general, the sale of a corporation's assets does not generate a tax at the shareholder level. However, if the selling corporation distributes the sale proceeds in a complete liquidation, each of the corporation's shareholders recognizes gain or loss (generally capital in nature) equal to the difference between the value of the liquidating distributions and the basis of the stock. The gain or loss generally is recognized at the time that the liquidation proceeds are received.

Description of Proposal

The proposal provides that if any partnership interest becomes worthless during the taxable year, the loss resulting therefrom is considered as a loss from the sale or exchange of a capital asset and such loss is recognized to the transferor partner at the time of the identifiable event establishing worthlessness. Thus, the character of the loss is generally capital, subject to the rules of section 751(relating to unrealized receivables and inventory items). Furthermore, the presence or absence of partnership liabilities is not determinative.

The proposal accelerates the timing of the loss resulting from a worthless security. Such loss is treated as a loss from the sale or exchange at the time of the identifiable event establishing worthlessness. The proposal expands the rules relating to worthless securities (sec. 165(g)) to certain securities issued by partnerships. It expands the definition of security to include a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a partnership, with interest coupons or in registered form.

The proposal also provides a deferral of losses in the case of a complete liquidation to which section 331 applies when the two corporations are members of the same controlled group.[184] No loss may be recognized by the distributee corporation (with respect to the stock or securities of the distributing corporation received in the liquidation) until the distributee corporation disposes of substantially all of the properties received in the liquidation to a party that is not related to the distributee corporation.[185]

The Secretary is instructed to issue any regulations or other guidance that may be necessary or appropriate, including regulations or other guidance to carry out the purposes of the proposal and to apply the principles of the proposal to liquidating corporation stock or securities owned by a corporation indirectly through one or more partnerships.

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[183] See *Austin Co. v. Commissioner, 71 T.C. 955*

[184] As defined in sec. 267(f).

[185] Related is defined to mean two corporations which are members of the same controlled group (as defined in sec. 267(f)) or controlled partnerships within the meaning of sec. 707(b)(1).

Effective Date

The proposal applies to taxable years beginning after December 31, 2021. In the case of liquidations described above, the proposal applies to liquidations on or after the date of enactment.

3. Adjusted basis limitation for divisive reorganization

Present Law

In a divisive reorganization under sections 368(a)(1)(D) and 355, a distributing corporation generally (1) transfers property to a section 368(c) controlled corporation in exchange for stock (and also in some cases for (i) money and other property of the controlled corporation and (ii) securities or other debt obligations of which the controlled corporation is the obligor) and (2) distributes the controlled stock to its shareholders (as well as cash or securities, if applicable).

There are three economically similar methods through which a distributing corporation can extract value from the controlled corporation in a divisive reorganization. First, the distributing corporation can reduce its liabilities by causing the subsidiary to assume them under section 357. Second, the distributing corporation can transfer money and other property received from the controlled corporation to the distributing corporation's creditors to satisfy its debt obligations, subject to section 361(b). Third, the distributing corporation can exchange the controlled corporation's debt securities for debt held by the distributing corporation's creditors.

The distributing corporation must recognize gain to the extent that the amount of the liability assumption, and money and other property transferred to the distributing corporation's creditors, exceeds the aggregate adjusted basis of the assets that the distributing corporation transfers to the controlled corporation in the divisive reorganization. However, the amount of the controlled corporation's debt securities that the distributing corporation may transfer to its creditors to reduce its debt without gain recognition is not limited under section 361.

Description of Proposal

The proposal amends section 361 to provide that a distributing corporation recognizes gain in a divisive reorganization under sections 368(a)(1)(D) and 355 to the extent that the amount of the controlled corporation's debt securities received by the distributing corporation and transferred to its creditors in connection with the divisive reorganization exceeds the aggregate adjusted basis of the assets transferred by the distributing corporation to the controlled corporation, as reduced by the amount of (i) the total amount of the liabilities of the distributing corporation assumed by the controlled corporation (within the meaning of section 357(c)), and (ii) the total amount of money and the fair market value of other property received by the distributing corporation from the controlled corporation.

Effective Date

The proposal applies to reorganizations occurring on or after the date of enactment.

4. Rents from prison facilities not treated as qualified income for purposes of REIT income tests

Present Law

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet several requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[186] the REIT must derive most of its income from passive, generally real estate-related, investments; and REIT assets must be primarily real estate-related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[187]

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Such income includes: rents from real property; gain from the sale or other disposition of real property (including interests in real property) that is not stock in trade of the taxpayer, inventory, or other property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[188] Qualifying rents from real property include rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property,[189] but do not include impermissible tenant service income.[190]

Description of Proposal

The proposal provides that qualifying rents from real property do not include any amount received or accrued, directly or indirectly, with respect to any real or personal property which is primarily used in connection with any correctional, detention, or penal facility.

Effective Date

The proposal applies to taxable years beginning after December 31, 2021.

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[186] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[187] Secs. 856 and 857.

[188] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

[189] Sec. 856(d)(1)(A) and (B).

[190] Sec. 856(d)(2)(C).

5. Modifications to exemption for portfolio interest

Present Law

Nonresident aliens and foreign corporations generally are subject to U.S. tax on only their U.S.-source income. There are two broad types of U.S.-source income of foreign taxpayers: (1) income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") and (2) income that is "effectively connected with the conduct of a trade or business within the United States" ("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.

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.[191] 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.[192] The categories of income subject to the 30-percent tax and the categories for which withholding is required generally are coextensive.[193]

Although FDAP income includes U.S.-source portfolio interest, such interest is exempt from the 30-percent gross-basis tax.[194] 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.[195] Portfolio interest, however, does not include interest received by a 10-percent shareholder.[196]

For this purpose, a 10-percent shareholder is, in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or, in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.[197]

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

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

[193] See secs. 1441 and 1442.

[194] Sec. 871(h)(1).

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

[196] Sec. 871(h)(3)(A).

[197] Sec. 871(h)(3)(B).

Description of Proposal

The proposal provides that, in the case of an obligation issued by a corporation, a 10-percent shareholder is (1) any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote and (2) any person who owns more than 10 percent of the total value of the stock of such corporation.

Effective Date

The proposal applies to obligations issued after the date of enactment.

6. Certain partnership interest derivatives

Present Law

In general, income arising from notional principal contracts are sourced based on the residence of the recipient of the payment.[198] However, if the notional principal contract income arises from a U.S. trade or business, the income is treated as "effectively connected" with the conduct of a U.S. trade or business, which is taxable at rates generally applicable to U.S. taxpayers.[199] The determination as to whether notional principal contract income arises from a U.S. trade or business depends on the facts and circumstances, including an analysis of whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States (the "asset-use test") and whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss (the "business-activities test").[200]

In general, if the interests in a partnership are traded on an established securities market or readily tradable on a secondary market (or the substantial equivalent thereof), then the partnership is treated as a corporation.[201] However, partnerships with certain passive income are excepted from the rule.[202]

In the case of notional principal contracts whose payments are calculated by reference to the income or gain of a publicly traded partnership that is not engaged in a U.S. trade or business, the general rule described above applies and the source of the payments is based on the residence of the recipient.

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[198] Treas. Reg. sec. 1.863-7(b)(1).

[199] Treas. Reg. sec. 1.863-7(b)(3).

[200] Treas. Reg. sec. 1.864-4(c).

[201] Sec. 7704(a).

[202] Sec. 7704(b) and (c).

Description of Proposal

The proposal treats notional principal contract income calculated by reference to the U.S. source income or gain of all publicly traded partnerships, including those that are not engaged in a U.S. trade or business, as "dividend equivalent amounts," sourced based on the residence of the payor rather than the recipient. As a result, these amounts are U.S.-source payments subject to 30-percent U.S. withholding tax (which may be reduced by tax treaty). To determine the portion of the notional principal contract income that is attributable to the income or gain of a publicly traded partnership that is subject to the new sourcing rule, the publicly traded partnerships themselves must provide relevant information in notices to the relevant withholding agent.

Effective Date

The proposal applies to payments made after the date that is 180 days after enactment.

7. Adjustments to earnings and profits of CFCs

Present Law

In general, a U.S. shareholder of a controlled foreign corporation (a "CFC")[203] must include currently its *pro rata* share of the CFC's subpart F income (generally passive income and certain other related-party income that is readily movable from one jurisdiction to another).[204] For any taxable year, however, a CFC's subpart F income generally is limited to the CFC's earning and profits ("E&P") for the taxable year.[205]

For that purpose, the E&P of a CFC is determined without regard to three rules in section 312(n): LIFO ("last-in, first-out") inventory adjustments, installment sales, and the completed contract method of accounting.[206] For other purposes, however, the E&P of a CFC is determined with regard to those three rules.

Take the rule for installment sales. In an installment sale, the purchase price is paid over time.[207] In general, under the installment method of accounting, income is included following

[203] 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 that own at least 10 percent of the stock (measured by vote or value). Secs. 951(b), 957, and 958.

[204] Subpart F comprises sections 951 through 965.

[205] Sec. 952(c)(1)(A).

[206] Sec. 952(c)(3) referring to the rules in sec. 312(n)(4)-(6).

[207] Sec. 453(b)(1) (defining an installment sale as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs).

the payments of the purchase price (*i.e.*, over time).[208] Under the rule in section 312(n), however, E&P is computed as if the corporation did not use the installment method.[209] In other words, in the case of an installment sale of a domestic corporation, E&P increases to reflect all gain otherwise deferred for income tax purposes.

In the case of an installment sale of a CFC, for purposes of determining subpart F inclusions, the E&P of the CFC is lower than E&P would otherwise be, because the rule in section 312(n) is disregarded.[210] For other purposes, however, the E&P of the CFC reflects all gain otherwise deferred for income tax purposes. Thus, in the case of an installment sale of a CFC, E&P for purposes of subpart F inclusions is lower than E&P for purposes of paying dividends (which may be eligible for the deduction under section 245A).

Description of Proposal

The proposal makes the special rule for E&P of a CFC for purposes of determining subpart F inclusion the general rule for E&P of a CFC. In other words, the proposal provides that for all purposes the E&P of a CFC is determined without regard to paragraphs (4) (LIFO), (5) (installment sales), and (6) (completed contract method of accounting) of section 312(n). Thus, in the case of an installment sale, the E&P of a CFC is lower for all purposes than E&P would otherwise be; in other words, under the proposal, E&P of a CFC generally follows the income tax treatment.

Effective Date

The proposal applies to taxable years of foreign corporations beginning after December 31, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

8. Certain dividends from CFCs to U.S. shareholders treated as extraordinary dividends

Present Law

If any corporation receives any extraordinary dividend with respect to any share of stock and the corporation has not held such stock for more than two years before the dividend announcement date, then (1) the corporation's basis in the stock is reduced (but not below zero) by the nontaxed portion of such dividends and (2) if the nontaxed portion of the dividends

[208] Sec. 453(c) (defining the installment method as a method of accounting under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price).

[209] Sec. 312(n)(5).

[210] Sec. 952(c)(3).

exceeds such basis, the excess is treated as gain from the sale or exchange of the stock for the taxable year in which the extraordinary dividend is received.[211]

An extraordinary dividend is any dividend the amount of which equals or exceeds a given percentage of the taxpayer's adjusted basis in the relevant stock. The percentage for preferred stock is five percent and ten percent for any other stock.[212]

In general, the nontaxed portion of a dividend is the amount of the dividend reduced by a deduction allowable with respect to the dividend under section 243, 245, or 245A.[213]

Description of Proposal

The proposal provides that any disqualified CFC dividend received from a controlled foreign corporation ("CFC") by taxpayer which is a U.S. shareholder[214] of such foreign corporation shall be treated as an extraordinary dividend to which subsection (a) applies without regard to the period the taxpayer held the stock of such foreign corporation.

For purposes of the proposal, disqualified CFC dividend means any dividend paid by a CFC to a taxpayer that is a U.S. shareholder of such foreign corporation that is attributable to earnings and profits which were earned, or gain with respect to property which accrued, during a period (i) such foreign corporation was not a CFC or (ii) such stock was not owned by a U.S. shareholder.

Finally, the proposal directs the Secretary to prescribe rules coordinating the application of section 1059 with other provisions of the Code, including section 1248.

Effective Date

The proposal applies to distributions made after the date of enactment.

9. Modification of rules for partnership interests held in connection with performance of services

Present Law

Section 1061 provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest (known as a carried interest) held by the taxpayer.[215] In general, if the three-year holding period requirement is not satisfied,

[211] Sec. 1059(a).

[212] Sec. 1059(c)(1).

[213] Sec. 1059(b).

[214] As defined in sec. 951(b).

[215] Section 1061 is effective for taxable years beginning after December 31, 2017.

section 1061 treats gain subject to the provision as short-term capital gain (taxed at ordinary rates). This rule applies notwithstanding the rules of section 83 relating to property transferred in connection with the performance of services or any election in effect under section 83(b) to include amounts in gross income in the year of transfer.

Gain subject to the provision to which the three-year holding period requirement applies means gain from, and loss from, the sale or exchange of a capital asset held for more than one year, to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.[216]

An applicable partnership interest is generally any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. An applicable partnership interest does not include a capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 upon the receipt or vesting of the partnership interest.

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets. Specified assets mean securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. Reporting requirements and regulatory authority are provided under the provision.[217]

<u>Description of Proposal</u>

Under the proposal, if one or more applicable partnership interests are held by a taxpayer at any time during a taxable year, the taxpayer's net applicable partnership gain for the taxable year is treated as short-term capital gain. Net applicable partnership gain means net long-term capital gain[218] determined by only taking into account the taxpayer's gains and losses with respect to applicable partnership interests, and any other amounts includable in gross income with respect to an applicable partnership interest that are treated as capital gain or are subject to

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[216] Sec. 1061(a)(2), referring to secs. 1222(3) and (4).

[217] The Department of Treasury and IRS have issued final regulations regarding the application of, and reporting for, section 1061. See T.D. 9945, 86 Fed. Reg. 5480, January 19, 2021.

[218] Net long-term capital gain is described in section 1222(7).

tax at the rate applicable to capital gain. The proposal thus expands the types of gain that are treated as short-term capital gain under section 1061.

Net applicable partnership gain generally does not include amounts realized after a five-year holding period, with certain exceptions. The holding period is three years for any taxpayer (other than a trust or estate) with adjusted gross income ("AGI") as determined under the provision of less than $400,000 for the taxable year.[219] The holding period is three years for any income with respect to any applicable partnership interest that is attributable to a real property trade or business.[220]

The proposal adds rules for measuring the five-year or three-year holding period, including for tiered entities. The holding period is measured from the latest of specified dates. The dates are (i) the date on which the taxpayer acquired substantially all of the applicable partnership interest with respect to which the amount is realized, (ii) the date on which the partnership in which such applicable partnership interest is held acquired substantially all of the assets held by such partnership, and (iii) if the partnership in which the taxpayer holds an applicable partnership interest owns, directly or indirectly, interests in one or more other partnerships, the dates determined by applying rules similar to the foregoing in the case of each such other partnership. The Treasury Secretary is directed to provide guidance in determining the amount of gain that is treated as short-term capital gain under these rules, as well as guidance as to any necessary and appropriate reporting to enable administration and carry out the purposes of the provision.

The proposal provides that the present-law rule with respect to certain services that are not taken into account in determining whether an interest is an applicable partnership interest applies to services with respect to a trade or business that is not an applicable trade or business.

The proposal modifies the definition of a specified asset, providing that a partnership interest is itself treated as a specified asset (except as otherwise provided by the Secretary) if the partnership has a direct or indirect interest in an asset that is a specified asset (that is, securities, commodities, real estate held for rental or investment, cash or cash equivalents, and options or derivative contracts with respect to any of the foregoing). Regulatory guidance may, for example, define a de minimis direct or indirect interest of a partnership in an asset that is not taken into account for this purpose.

The proposal gives regulatory authority to provide that statutory exclusions from the definition of an applicable partnership interest do not apply, for example, when the application of an exception would not carry out the purposes of section 1061. The proposal also clarifies that

[219] AGI as determined under the provision is AGI determined without regard to sections 911, 931, or 933. These sections provide certain income exclusions for U.S. citizens or residents living abroad and exclusions for certain income from sources within certain possessions and within Puerto Rico.

[220] For this purpose, a real property trade or business is defined as in section 469(c)(7)(C) as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

the exception for ownership by a corporation of an interest that would otherwise be an applicable partnership interest applies only to C corporations.

The proposal modifies the rule relating to transfers of applicable partnership interests to provide that transfer of an applicable partnership interest requires recognition of gain notwithstanding any other Federal income tax rules.

The proposal requires the issuance of Treasury guidance to prevent the avoidance of the purposes of the proposal through the distribution of property by a partnership or through a carry waiver (*e.g.*, the waiver of gain subject to this provision in return for a future allocation of income, gain, or property). The guidance also must apply the rules of section 1061 in the case of financial instruments, contracts, or interests in entities other than partnerships to the extent necessary or appropriate to carry out the purposes of the provision.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

10. Limitation on certain special rules for section 1202 gains

Present Law

Exclusion of gain on sale of small business stock

In general

A taxpayer other than a corporation may exclude 50 percent of the gain from the sale of qualified small business stock acquired at original issue and held for at least five years.[221] The amount of gain eligible for the exclusion by an individual with respect to the stock of any corporation is the greater of (1) ten times the taxpayer's basis in the stock, or (2) $10 million (reduced by the amount of eligible gain excluded by the taxpayer in prior years).[222] To qualify as a small business, before and immediately after the issuance, the aggregate gross assets (*i.e.*, cash plus aggregate adjusted basis of other property) held by the corporation may not exceed $50 million.[223] The corporation also must meet certain active trade or business requirements. Only C corporation stock may qualify as qualified small business stock.[224]

[221] Sec. 1202(a)(1) and (2).

[222] Sec. 1202(b)(1).

[223] Sec. 1202(d)(1)(A) and (B).

[224] Sec. 1202(c)(1).

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax rates applicable to the net capital gain of individuals.[225] Seven percent of the excluded gain is an alternative minimum tax preference.[226]

Special rules for certain stock acquired after February 17, 2009

For qualified small business stock acquired after February 17, 2009, and before September 28, 2010, the percent of gain which may be excluded is increased to 75 percent ("75-percent exclusion rule").[227]

For qualified small business stock acquired after September 27, 2010, the percent of gain which may be excluded is increased to 100 percent and the minimum tax preference does not apply ("100-percent exclusion rule").[228]

Rollover of gain from sale of small business stock

An individual may elect to roll over tax-free any gain realized on the sale of qualified small business stock held more than six months to the extent of the taxpayer's cost of purchasing other qualified small business stock within 60 days of the sale.[229]

Description of Proposal

The proposal limits the application of the 75-percent exclusion and 100-percent exclusion rules to taxpayers with adjusted gross income ("AGI") of less than $400,000. The proposal also provides that the 75-percent exclusion and 100-percent exclusion rules do not apply to trusts and estates. Consequently, for qualified small business stock acquired any time after February 17, 2009, taxpayers with AGI equal to or greater than $400,000, as well as all trusts and estates, may only exclude 50 percent of the gain for income tax purposes from the sale of qualified small business stock.

For purposes of the proposal, AGI is determined without regard to sections 911 (foreign earned income exclusion), 931 (exclusion of income for a bona fide resident of American Samoa), and 933 (exclusion for a bona fide resident of Puerto Rico).

AGI is also determined without regard to the exclusion of gain from the sale of qualified small business stock. Thus, the full amount of such gain is included in AGI for purposes of determining the applicable exclusion.

[225] Sec. 1(h)(4), (7).

[226] Sec. 57(a)(7).

[227] Sec. 1202(a)(3).

[228] Sec. 1202(a)(4).

[229] Sec. 1045(a).

Effective Date

In general, the proposal applies to sales or exchanges of stock on or after September 13, 2021. However, the proposal does not apply to any sale or exchange of stock executed pursuant to a written binding contract which was in effect on September 12, 2021, and which is not later materially modified.

11. Rules relating to common control

Present Law

Aggregation rules are applied under the tax law to treat multiple taxpayers as a single taxpayer for purposes of particular tax rules. The section 52 aggregation rules generally treat groups of corporations and other entities under common control as a single employer.[230] Corporate entities making up the same controlled group of corporations are treated as a single employer.[231] A separate rule in section 52 aggregates organizations under common control.[232] Thus, partnerships (and other non-corporate entities such as sole proprietorships) may be aggregated under section 52(b).

Under the aggregation rules of section 52(b), all employees of trades or business (whether or not incorporated) that are under common control are treated as employed by a single employer.[233] The regulations generally apply a vote or value ownership test whereby a parent-subsidiary group, a brother-sister group or a combined group may be treated as a single taxpayer. In broad terms, a parent-subsidiary group requires the organizations to be linked through 50-percent-or-greater direct ownership interests. A brother-sister group generally only exists in the case of closely held entities, and a combined group requires both a parent-subsidiary group and a brother-sister group.

Aggregation under section 52 applies to taxpayers conducting a trade or business.

Description of Proposal

The proposal provides that a trade or business for purposes of section 52(b) includes any activity treated as trade or business under section 469(c)(5) (activity involving research or experimentation) or section 469(c)(6) (including certain investment activity). Thus, for example,

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230 The aggregation rules of section 52 (originally designed to assist taxpayers in computing the work opportunity tax credit) are applied by many other Code provisions. Such other Code provisions are themselves cross-referenced, broadening the reach of section 52's aggregation rules. For example, section 163(j)(3)'s small business exception references section 448 and thus requires the application of the aggregation rules of section 52 to determine whether a taxpayer is subject to section 163(j)'s business interest expense limitation.

231 Sec. 52(a). A controlled group is defined by reference to section 1563(a).

232 Section 52(b).

233 An entity generally must include the gross receipts of another entity in which it has a controlling interest (generally, a more-than-50-percent interest). Sec. 52; Treas. Reg. sec. 1.52-1.

if a partnership engages in activity that gives rise to a section 212 deduction, such partnership may be aggregated under section 52(b).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

12. Wash sales and constructive sales

Present Law

Wash sales

In general, a loss claimed by a taxpayer with respect to any sale or other disposition of shares of stock or securities is not allowed if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities.[234] In other words, a loss claimed with respect to a wash sale is not allowed.

The basis of the stock or securities acquired (or the contract or option entered into) that resulted in denial of the loss from the sale or other disposition of substantially identical stock or securities is the basis of the stock or securities so sold or disposed of.[235] In other words, the loss is deferred. The basis is increased or decreased by the difference, if any, between the price at which the stock or securities were acquired and the price at which the substantially identical stock or securities were sold or otherwise disposed of.

Constructive sales

In general, in the case of a constructive sale of an appreciated financial position, a taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale.[236]

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[234] Sec. 1091(a). For this purpose, stock or securities generally includes contracts or options to acquire or sell stock or securities.

[235] Sec. 1091(d).

[236] Sec. 1259(a)(1). Any gain or loss realized after the constructive sale with respect to the position is adjusted to reflect any gain taken into account as a result of the constructive sale. In addition, the holding period of the position is determined as if the position were originally acquired on the date of the constructive sale. Sec. 1259(a)(2).

In general, an appreciated financial position is any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value.[237]

A taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) (A) enters into a short sale of the same or substantially identical property, (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property, (C) enters into a futures or forward contract to deliver the same or substantially identical property, (D) in the case of an appreciated financial position that is a short sale or a contract described in (B) or (C) with respect to any property, acquires the same or substantially identical property, or (E) to the extent prescribed by the Secretary in regulations, enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in any of the preceding sentence.

Description of Proposal

Wash sales

The proposal modifies the wash sale rules to apply to a loss claimed with respect to any sale or other disposition of a specified asset. Other specified assets include (1) any security described in subparagraph (A), (B), (C), (D), or (E) of section 475(c)(2), (2) any foreign currency, (3) any commodity described in subparagraph (A), (B), or (C) of section 475(e)(2), (4) any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary. Except as provided in regulations, specified assets include contracts or options to acquire or sell any specified assets. The proposal also provides a business needs and hedging exception for foreign currencies and commodities (as defined).

The proposal expands application of the wash sale rules to acquisition of substantially identical specified assets by the taxpayer or a related party. In the case of any acquisition of substantially identical specified assets by a related party (other than the taxpayer's spouse), the basis of the substantially identical specified assets is not adjusted to include the disallowed loss. If the substantially identical specified assets are acquired by the taxpayer (or the taxpayer's spouse), the basis of the acquired specified assets is increased by the amount of the disallowed loss.

Constructive sales

The proposal adds digital asset (as defined above) to the definition of appreciated financial position. Thus, a constructive sale of a digital asset is subject to the general rule for constructive sales, such that a taxpayer must recognize gain as if the position with respect to the

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[237] Sec. 1259(b)(1). A position is an interest, including a futures or forward contract, short sale, or option. Sec. 1259(b)(3).

digital asset were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale.

Effective Date

The proposal applies to sales and other dispositions after December 31, 2021.

F. Tax Increases for High-Income Individuals

1. Increase in top marginal individual income tax rate

Present Law

In general

To determine regular tax liability, individual, estate, and trust taxpayers generally must apply the tax rate schedules (or the tax tables) to their regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income bracket increases.

Tax rate schedules

Separate rate schedules apply based on an individual's filing status. Public Law 115-97 (the "2017 Tax Act") changed the prior-law rate schedules for taxable years beginning after December 31, 2017, and beginning before January 1, 2026. For 2022, the regular individual, estate, and trust income tax rate schedules are projected to be as follows:

Table 1.–Projected Federal Individual, Estate, and Trust Income Tax Rates for 2022[1]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $10,250	10% of the taxable income
Over $10,250 but not over $41,675	$1,025 plus 12% of the excess over $10,250
Over $41,675 but not over $88,850	$4,796 plus 22% of the excess over $41,675
Over $88,850 but not over $169,600	$15,174.50 plus 24% of the excess over $88,850
Over $169,600 but not over $215,375	$34,554.50 plus 32% of the excess over $169,600
Over $215,375 but not over $538,475	$49,202.50 plus 35% of the excess over $215,375
Over $538,475	$162,287.50 plus 37% of the excess over $538,475
Heads of Households	
Not over $14,600	10% of the taxable income
Over $14,600 but not over $55,750	$1,460 plus 12% of the excess over $14,600
Over $55,750 but not over $88,850	$6,398 plus 22% of the excess over $55,750
Over $88,850 but not over $169,600	$13,680 plus 24% of the excess over $88,850
Over $169,600 but not over $215,350	$33,060 plus 32% of the excess over $169,600
Over $215,350 but not over $538,450	$47,700 plus 35% of the excess over $215,350
Over $538,450	$160,785 plus 37% of the excess over $538,450

If taxable income is:	Then income tax equals:
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $20,500	10% of the taxable income
Over $20,500 but not over $83,350	$2,050 plus 12% of the excess over $20,500
Over $83,350 but not over $177,700	$9,592 plus 22% of the excess over $83,350
Over $177,700 but not over $339,200	$30,349 plus 24% of the excess over $177,700
Over $339,200 but not over $430,750	$69,109 plus 32% of the excess over $339,200
Over $430,750 but not over $646,150	$98,405 plus 35% of the excess over $430,750
Over $646,150	$173,795 plus 37% of the excess over $646,150
Married Individuals Filing Separate Returns	
Not over $10,250	10% of the taxable income
Over $10,250 but not over $41,675	$1,025 plus 12% of the excess over $10,250
Over $41,675 but not over $88,850	$4,796 plus 22% of the excess over $41,675
Over $88,850 but not over $169,600	$15,174.50 plus 24% of the excess over $88,850
Over $169,600 but not over $215,375	$34,554.50 plus 32% of the excess over $169,600
Over $215,375 but not over $323,075	$49,202.50 plus 35% of the excess over $215,375
Over $323,075	$86,897.50 plus 37% of the excess over $323,075
Estates and Trusts	
Not over $2,700	10% of the taxable income
Over $2,700 but not over $9,850	$270 plus 24% of the excess over $2,700
Over $9,850 but not over $13,450	$1,986 plus 35% of the excess over $9,850
Over $13,450	$3,246 plus 37% of the excess over $13,450

[1] Joint Comittee staff calculations.

For 2026, after the expiration of changes made by the 2017 Tax Act, the regular individual, estate, and trust income tax rate schedules are projected to be as follows:

Table 2.–Projected Federal Individual, Estate, and Trust Income Tax Rates for 2026[1]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $11,200	10% of the taxable income
Over $11,200 but not over $45,450	$1,120 plus 15% of the excess over $11,200
Over $45,450 but not over $110,100	$6,257.50 plus 25% of the excess over $45,450
Over $110,100 but not over $229,600	$22,420 plus 28% of the excess over $110,100
Over $229,600 but not over $499,200	$55,880 plus 33% of the excess over $229,600
Over $499,200 but not over $501,250	$144,848 plus 35% of the excess over $499,200
Over $501,250	$145,565.50 plus 39.6% of the excess over $501,250
Heads of Households	
Not over $16,000	10% of the taxable income
Over $16,000 but not over $60,900	$1,600 plus 15% of the excess over $16,000
Over $60,900 but not over $157,200	$8,335 plus 25% of the excess over $60,900
Over $157,200 but not over $254,600	$32,410 plus 28% of the excess over $157,200
Over $254,600 but not over $499,200	$59,682 plus 33% of the excess over $254,600
Over $499,200 but not over $532,600	$140,400 plus 35% of the excess over $499,200
Over $532,600	$152,090 plus 39.6% of the excess over $532,600
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $22,400	10% of the taxable income
Over $22,400 but not over $90,900	$2,240 plus 15% of the excess over $22,400
Over $90,900 but not over $183,450	$12,515 plus 25% of the excess over $90,900
Over $183,450 but not over $279,550	$35,652.50 plus 28% of the excess over $183,450
Over $279,550 but not over $499,200	$62,560.50 plus 33% of the excess over $279,550
Over $499,200 but not over $563,900	$135,045 plus 35% of the excess over $499,200
Over $563,900	$157,690 plus 39.6% of the excess over $563,900
Married Individuals Filing Separate Returns	
Not over $11,200	10% of the taxable income
Over $11,200 but not over $45,450	$1,120 plus 15% of the excess over $11,200
Over $45,450 but not over $91,725	$6,257.50 plus 25% of the excess over $45,450
Over $91,725 but not over $139,775	$17,826.25 plus 28% of the excess over $91,725

If taxable income is:	Then income tax equals:
Over $139,775 but not over $249,600	$31,280.25 plus 33% of the excess over $139,775
Over $249,600 but not over $281,950	$67,522.50 plus 35% of the excess over $249,600
Over $281,950	$78,845 plus 39.6% of the excess over $281,950
Estates and Trusts	
Not over $3,050	15% of the taxable income
Over $3,050 but not over $7,200	$457.50 plus 25% of the excess over $3,050
Over $7,200 but not over $10,950	$1,495 plus 28% of the excess over $7,200
Over $10,950 but not over $14,950	$2,545 plus 33.0% of the excess over $10,950
Over $14,950	$3,865 plus 39.6% of the excess over $14,950

[1] Joint Committee staff calculations.

Description of Proposal

The proposal increases the top individual, estate, and trust income tax rate of 37 percent to 39.6 percent and reduces the dollar amounts at which the 39.6-percent bracket begins. For 2022, the proposal modifies the start of the 39.6 percent bracket to be $400,000 for singles, $425,000 for heads of households, $450,000 for married individuals filing jointly and surviving spouses, and $225,000 for married individuals filing separately. These amounts are adjusted for inflation starting in 2023. Under the proposal, for 2022, the regular individual income tax rate schedules are projected to be as follows (changes from present law are in bold):

Table 3.–Federal Individual, Estate, and Trust Income Tax Rates for 2022 Under the Proposal[1]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $10,250	10% of the taxable income
Over $10,250 but not over $41,675	$1,025 plus 12% of the excess over $10,250
Over $41,675 but not over $88,850	$4,796 plus 22% of the excess over $41,675
Over $88,850 but not over $169,600	$15,174.50 plus 24% of the excess over $88,850
Over $169,600 but not over $215,375	$34,554.50 plus 32% of the excess over $169,600
Over $215,375 but not over **$400,000**	$49,202.50 plus 35% of the excess over $215,375
Over **$400,000**	**$113,821.25** plus **39.6%** of the excess over **$400,000**

If taxable income is:	Then income tax equals:
Heads of Households	
Not over $14,600	10% of the taxable income
Over $14,600 but not over $55,750	$1,460 plus 12% of the excess over $14,600
Over $55,750 but not over $88,850	$6,398 plus 22% of the excess over $55,750
Over $88,850 but not over $169,600	$13,680 plus 24% of the excess over $88,850
Over $169,600 but not over $215,350	$33,060 plus 32% of the excess over $169,600
Over $215,350 but not over **$425,000**	$47,700 plus 35% of the excess over $215,350
Over **$425,000**	**$121,077.50** plus **39.6%** of the excess over **$425,000**
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $20,500	10% of the taxable income
Over $20,500 but not over $83,350	$2,050 plus 12% of the excess over $20,500
Over $83,350 but not over $177,700	$9,592 plus 22% of the excess over $83,350
Over $177,700 but not over $339,200	$30,349 plus 24% of the excess over $177,700
Over $339,200 but not over $430,750	$69,109 plus 32% of the excess over $339,200
Over $430,750 but not over **$450,000**	$98,405 plus 35% of the excess over $430,750
Over **$450,000**	**$105,142.50** plus **39.6%** of the excess over **$450,000**
Married Individuals Filing Separate Returns	
Not over $10,250	10% of the taxable income
Over $10,250 but not over $41,675	$1,025 plus 12% of the excess over $10,250
Over $41,675 but not over $88,850	$4,796 plus 22% of the excess over $41,675
Over $88,850 but not over $169,600	$15,174.50 plus 24% of the excess over $88,850
Over $169,600 but not over $215,375	$34,554.50 plus 32% of the excess over $169,600
Over $215,375 but not over **$225,000**	$49,202.50 plus 35% of the excess over $215,375
Over **$225,000**	**$52,571.25** plus **39.6%** of the excess over **$225,000**
Estates and Trusts	
Not over $2,700	10% of the taxable income
Over $2,700 but not over $9,850	$270 plus 24% of the excess over $2,700
Over $9,850 but not over $13,450	$1,986 plus 35% of the excess over $9,850
Over $13,450	$3,246 plus **39.6%** of the excess over $13,450

[1] Joint Committee staff calculations.

The proposal's change to lower the start of the brackets for the top marginal rate also applies to taxable years beginning after December 31, 2025. As a result, the 35-percent bracket is eliminated for taxable years beginning after December 31, 2025.[238] Under the proposal, for 2026, the regular individual income tax rate schedules are projected to be as follows (changes from present law are in bold):

Table 4.–Federal Individual, Estate, and Trust Income Tax Rates for 2026 Under the Proposal[1]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $11,200	10% of the taxable income
Over $11,200 but not over $45,450	$1,120 plus 15% of the excess over $11,200
Over $45,450 but not over $110,100	$6,257.50 plus 25% of the excess over $45,450
Over $110,100 but not over $229,600	$22,420 plus 28% of the excess over $110,100
Over $229,600 but not over **$437,700**	$55,880 plus 33% of the excess over $229,600
Over **$437,700**	**$124,553** plus **39.6%** of the excess over **$437,700**
Heads of Households	
Not over $16,000	10% of the taxable income
Over $16,000 but not over $60,900	$1,600 plus 15% of the excess over $16,000
Over $60,900 but not over $157,200	$8,335 plus 25% of the excess over $60,900
Over $157,200 but not over $254,600	$32,410 plus 28% of the excess over $157,200
Over $254,600 but not over **$465,100**	$59,682 plus 33% of the excess over $254,600
Over **$465,100**	**$129,147** plus **39.6%** of the excess over **$465,100**
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $22,400	10% of the taxable income
Over $22,400 but not over $90,900	$2,240 plus 15% of the excess over $22,400
Over $90,900 but not over $183,450	$12,515 plus 25% of the excess over $90,900
Over $183,450 but not over $279,550	$35,652.50 plus 28% of the excess over $183,450
Over $279,550 but not over **$492,450**	$62,560.50 plus 33% of the excess over $279,550
Over **$492,450**	**$132,817.50** plus **39.6%** of the excess over **$492,450**

[238] Other rates and brackets revert to levels from prior law in effect before enactment of the 2017 Tax Act (adjusted appropriately for inflation) for taxable years beginning after December 31, 2025.

Married Individuals Filing Separate Returns	
Not over $11,200	10% of the taxable income
Over $11,200 but not over $45,450	$1,120 plus 15% of the excess over $11,200
Over $45,450 but not over $91,725	$6,257.50 plus 25% of the excess over $45,450
Over $91,725 but not over $139,775	$17,826.25 plus 28% of the excess over $91,725
Over $139,775 but not over **$246,225**	$31,280.25 plus 33% of the excess over $139,775
Over **$246,225**	**$66,408.75** plus **39.6%** of the excess over **$246,225**
Estates and Trusts	
Not over $3,050	15% of the taxable income
Over $3,050 but not over $7,200	$457.50 plus 25% of the excess over $3,050
Over $7,200 but not over $14,950	$1,495 plus 28% of the excess over $7,200
Over $10,950 but not over $14,950	$2,545 plus 33% of the excess over $10,950
Over $14,950	$3,865 plus 39.6% of the excess over $14,950

[1] Joint Committee staff calculations.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

2. Increase in capital gains rate for certain high-income individuals

Present Law

Preferential rates on capital gain and qualified dividends

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income.[239]

For individuals, estates, and trusts, any net capital gain is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. [240] Gain or loss

[239] Gain from the sale of a taxpayer's principal residence may be excluded up to certain limits if certain conditions are met. See sec. 121.

[240] See sec. 1222.

is treated as long-term if the asset is held for more than one year.[241] Qualified dividend income generally is taxed at the same rate as net capital gain.[242]

Capital losses generally are deductible in full against capital gains.[243] In addition, individual, trust, and estate taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year.[244] Any remaining unused capital losses may be carried forward indefinitely to another taxable year.[245]

The maximum rate of tax on the adjusted net capital gain depends on the taxpayer's taxable income and filing status. These maximum rates apply for purposes of both the regular tax and the alternative minimum tax. For 2021, the adjusted net capital gain rate schedules are as follows:

Table 5.–Adjusted Net Capital Gain Maximum Rates for 2021

Filing Status and Rate Start Amount (Taxable Income)					Rate
Single Individuals	Heads of Households	Married Individuals Filing Joint Returns and Surviving Spouses	Married Individuals Filing Separate Returns	Estates and Trust	
$0	$0	$0	$0	$0	0%
$40,400	$54,100	$80,800	$40,400	$2,700	15%
$445,850	$473,750	$501,600	$250,800	$13,250	20%

The breakpoints between the zero- and 15-percent rates (the "15-percent breakpoints") and the 15- and 20-percent rates (the "top capital-gain breakpoints") do not correspond to the ordinary income breakpoints.[246]

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[241] *Ibid*.

[242] Sec. 1(h).

[243] Sec. 1211(b).

[244] *Ibid*.

[245] Sec. 1212(b).

[246] Sec. 1(j)(5) For taxable years beginning before January 1, 2018, the start of the 15-percent breakpoints corresponded to the breakpoints that began the then-in-effective 25 percent ordinary rate, while the start of the top capital-gain breakpoints corresponded to the breakpoints that began the then-in-effective 39.6 percent ordinary rate. See sec. 1(h)(1).

Additionally, in certain cases, there are additional higher capital gains rate brackets. A maximum 25 percent rate applies to unrecaptured section 1250 gain. Unrecaptured section 1250 gain arises upon the sale of depreciable real property, gain from which may be treated as long-term gain under section 1231 (for property used in a trade or business). Upon the sale of such property, a portion of the gain attributable to depreciation recapture is treated as capital gain but taxed at a higher rate.[247] A maximum 28 percent rate applies to gain from the sale of collectibles.[248]

The preferential capital gains rates apply for both the regular income tax as well as the alternative minimum tax ("AMT").

Conforming provisions

Certain provisions in the Internal Revenue Code and in the U.S Code operate with a rate equal to the highest marginal regular capital gains rate: (1) the accumulated earnings tax,[249] (2) the personal holding company tax,[250] (3) the FIRPTA withholding rules for certain distributions relating to dispositions of real property interests,[251] and (4) 46 U.S.C. sec. 53511(f)(2).

Section 15

If tax rates change during a taxable year, section 15 provides rules for apportioning taxable income for the year between the portion of the year ending with the day before the effective date of the change and the portion beginning with the effective date.[252]

Description of Proposal

The proposal aligns the top capital-gain breakpoints with the breakpoints that begin the top ordinary rate.[253] The 15-percent breakpoints is not changed.

The proposal increases the top regular capital gains rate for individuals, estates, and trusts from 20 percent to 25 percent. The rates for unrecaptured section 1250 gain and collectible gain remain the same. The rate increase applies for purposes of both the regular tax and the AMT.

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[247] Sec. 1(h)(1)(E) and (6).

[248] The term collectible is defined in section 408(m). In addition, certain gain from the sale of qualified small business stock is subject to a maximum 28 percent rate.

[249] Sec. 531.

[250] Sec. 541.

[251] Sec. 1445(e)(1) and (6).

[252] Sec. 15.

[253] The preceding proposal of the bill lowers the top ordinary income breakpoints and raises the top ordinary income rate to 39.6 percent. This proposal aligns the top capital-gain breakpoints with those breakpoints.

Conforming changes are made to the accumulated earnings tax, (2) the personal holding company tax, (3) the FIRPTA withholding rules for certain distributions relating to dispositions of real property interests, and (4) 46 U.S.C. sec. 53511(f)(2).

The proposal provides that section 15 does not apply to the rate increase.

Effective Date

The proposal to align the top capital-gain breakpoints with the breakpoints that begin the top ordinary rate is effective for taxable years beginning after December 31, 2021.

The proposal to increase the top regular capital gains rate is effective for taxable years ending after the date of introduction (September 13, 2021).

The conforming change to the FIRPTA withholding rules applies to dispositions made after the effective date of the proposal.

The proposal has a transition rule for the taxable year including the date of introduction. Under this rule, gains and losses for the portion of the taxable year on or before the date of introduction are separately taken into account, and net capital gain with respect to such gain and losses is subject to a top marginal regular capital gains rate of 20 percent. Gains and losses for the portion of the taxable year after the date of introduction are also separately taken into account, and net capital with respect to such gain and losses is subject to a top marginal regular capital gains rate of 25 percent. A similar transition rule applies for purposes of the AMT. If the taxpayer has gains or losses allocated from a passthrough entity, the determination of when the gain or loss is taken into account is made at the entity level.

For purposes of the transition rule, capital gain recognized in the portion of the taxable year after the date of introduction shall be treated as recognized in the portion of the taxable year on or before the date of introduction if the gain arises from a transaction that occurs pursuant to a written binding contract entered into on or before the date of introduction. This safe harbor shall not apply if the written binding contract is modified in any material respect after the date of introduction.

3. Application of net investment income tax to trade or business income of certain high income individuals

Present Law

In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal

Insurance Contributions Act ("FICA").[254] A similar tax is imposed on the self-employment income of an individual under the Self-Employment Contributions Act ("SECA").[255]

FICA

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[256] The amount of wages subject to this component is capped at $142,800 for 2021. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped.

The employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount for the additional 0.9 percent is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. The threshold amount is not indexed for inflation.[257] The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax. The employee portion of the FICA tax is collected through withholding from wages.[258]

SECA

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $142,800 for 2021. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped. An additional 0.9 percent HI tax applies to self-employment income in excess of the same threshold amount that is applicable under FICA (reduced by FICA wages).[259]

For SECA tax purposes, self-employment income generally means net earnings from self-employment subject to a de minimis floor, but, for the OASDI component, self-employment income is limited to the annual cap less wages paid to the individual during the taxable year. Net earnings from self-employment generally includes the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the

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[254] See Chapter 21 of the Code.

[255] Sec. 1401.

[256] Secs. 3101 and 3111.

[257] Sec. 3101(b)(2).

[258] Sec. 3102.

[259] Sec. 1401(b)(2).

trade or business that are allowed under the self-employment tax rules.[260] Net earnings from self-employment generally includes the distributive share of income or loss from any trade or business of a partnership in which the individual is a partner, subject to certain exceptions.

Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gain or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

Trust funds

Under the Social Security Act, OASDI taxes are directed to Treasury trust funds that provide Social Security benefits, and HI taxes are directed to the Federal Hospital Insurance Trust Fund.

S corporation shareholders

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.[261]

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation. A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income.

An S corporation shareholder's pro rata share of S corporation income is not subject to SECA tax.[262] Nevertheless, courts have held that an S corporation shareholder is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. The case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable

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[260] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. However, for a discussion of why the present law deduction does not provide exact parity with FICA taxes and a proposal to modify the deduction, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 27, 2005), at pp. 74-79. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[261] Sec. 1366.

[262] See Rev. Rul. 59-221, 1959-1 C.B. 225, and Rev. Rul. 74-44, 1974-1 C.B. 287. This treatment differs from a partner's distributive share of income or loss from the partnership's trade or business, which is generally subject to SECA tax, as described below. Sec. 1402(a).

compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[263]

Partners

In general

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, deduction, gain and loss.[264]

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes. Rather, a partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above[265]).

Limited partners

An exclusion from SECA applies in certain circumstances for limited partners of a partnership.[266] Under this rule, in determining a limited partner's net earnings from self-employment, an exclusion is generally provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[267]

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[263] See the discussion of case law in, *e.g.*, Thomas L. Dickens and Judson R. Jahn, "Reasonable Compensation For S Corporation Shareholder-Employees," 94 *Practical Tax Strategies* 159, April 2015 (also listing websites with ranges of reasonable compensation for various sectors); Richard Winchester, "The Gap in the Employment Tax Gap," 20 *Stanford Law and Policy Review* 127, 2009; James Parker and Claire Y. Nash, "Anticipate Close Inspection of Closely Held Company Pay Practices - Part I," 80 *Practical Tax Strategies* 215, April 2008; "Renewed Focus on S Corp. Officer Compensation," AICPA Tax Division's S Corporation Taxation Technical Resource Panel, *Tax Advisor,* May 2004, at 280. See also Treasury Inspector General for Tax Administration, Department of the Treasury, *Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can be Taken*, (TIGTA 2021-30-042), August 11, 2021.

[264] Secs. 701 and 702.

[265] Sec. 1402(a).

[266] Sec. 1402(a)(13).

[267] In *Renkemeyer, Campbell, & Weaver, LLP v. Commissioner*, the Tax Court held that distributive shares of limited partners in a law firm that was an LLP (limited liability partnership under applicable State law) of partnership income "arising from the legal services they performed in their capacity as partners in the law firm are subject to self-employment tax" in the years at issue. 136 T. C. 137, 150 (2011); see also Amy S. Elliott, "Tax

The owners of a limited liability company that is classified as a partnership for Federal tax purposes are treated as partners for tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.

Net investment income ("NII") tax

Rate and application of the tax

An additional tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income ("AGI") over the threshold amount.[268]

The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.[269] The threshold amount is not indexed for inflation. Modified AGI is AGI increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).[270]

The tax is subject to the individual estimated tax provisions.[271] The tax is not deductible for income tax purposes.

Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," *Tax Notes Today*, March 11, 2011. The Tax Court has continued to apply a functional test in evaluating whether a taxpayer's interest in a partnership is sufficiently analogous to a limited partner interest for income attributable to the interest to be covered by the section 1402(a)(13) exclusion. See, *e.g.*, *Joseph v. Commissioner*, T.C.M. 2020-65, 20-21 (2020) ("[W]e concluded in *Renkemeyer* that an interest other than a limited partner interest could be treated as such for purposes of that section only if the holder is merely a passive investor in the entity who does not actively participate in the entity's business operations.")

In *Howell v. Commissioner*, the Tax Court concluded that a member of a limited liability company (treated as a partnership for tax purposes) who received guaranteed payments had performed services for the partnership and therefore was required to include the payments in net earnings from self-employment. T.C. Memo. 2012-303, Nov. 1, 2012. Similarly in *Riether v. U.S.*, the court held that the two members of a diagnostic imaging LLC should have treated all their income from the LLC as self-employment income because they participated in the partnership business. 919 F.Supp.2d 1140 (D.N.M. 2012).

In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

[268] Sec. 1411(a)(1).

[269] Sec. 1411(b).

[270] Sec. 1411(d).

[271] Sec. 6654(a).

Net investment income definition

Net investment income is investment income reduced by the deductions properly allocable to such income.[272]

Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than such income derived in the ordinary course of any trade or business to which the tax does not apply), (ii) other gross income derived from any trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.[273]

Deductions properly allocable to net investment income may include net operating loss deductions allowed under section 172.[274] Treasury regulations provide rules for calculating section 1411 net operating loss amounts of a net operating loss deduction for a taxable year.

The NII tax applies if a trade or business is a passive activity with respect to the taxpayer, or if the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). In general, for a trade or business to be a passive activity (within the meaning of section 469) with respect to a taxpayer, the taxpayer does not materially participate in the trade or business (with certain exceptions).

Consequently, the NII tax generally does not apply to income or gain from a trade or business conducted as a sole proprietor, partnership, or S corporation, if the individual taxpayer materially participates in the trade or business activity. The NII tax does not apply to wages of an employee.

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.[275]

Income, gain, or loss on working capital is not treated as derived from a trade or business. Investment income does not include distributions from a qualified retirement plan. Nor does net

[272] Sec. 1411(c).

[273] Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax. See Treas. Reg. sec. 1.1411-1(d)(4).

[274] Treas. Reg. sec. 1.1411-4(f)(2)(iv) and (h).

[275] For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

investment income include amounts subject to SECA tax; thus, in effect, the application of SECA tax is determined before NII is determined.

Application of NII tax to trusts and estates

In the case of an estate or trust, the NII tax is 3.8 percent of the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins[276] ($13,050 for taxable years beginning in 2021).[277] Adjusted gross income is determined as provided in section 67(e), which provides that trusts and estates may deduct certain administrative expenses,[278] the applicable personal exemption,[279] and distributions made to beneficiaries[280] as part of the calculation of adjusted gross income.[281]

The tax does not apply to a trust all the unexpired interests in which are devoted to charitable purposes.[282] It also does not apply to (1) a trust that is exempt from tax under section 501, (2) a charitable remainder trust exempt from tax under section 664, (3) a trust, fund, or account exempt from tax under subtitle A, (4) a grantor trust, (5) Electing Alaska Native Settlement Trusts subject to taxation under section 646; (6) Cemetery Perpetual Care Funds to which section 642(i) applies; or (7) foreign trusts or estates.[283]

A trust or estate may materially participate in a trade or business, making the trade or business a non-passive trade or business the income from which is not subject to the NII tax. The Internal Revenue Service has taken the position that material participation is determined by whether the fiduciary of the trust or estate is involved in the operations of the activities of the trade or business on a regular, continuous, and substantial basis.[284]

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[276] Sec. 1411(a)(2).

[277] Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

[278] The trust or estate may deduct costs which are paid or incurred in connection with the administration of the trust or estate and which would not have been incurred if the property were not held in such trust or estate.

[279] See sec. 642(b) (providing the personal exemption amounts for trusts and estates).

[280] Secs. 651, 661.

[281] Adjusted gross income is otherwise calculated in the same manner as it is for individuals. Sec. 67(e); see also sec. 62.

[282] Sec. 1411(e).

[283] Treas. Reg. 1.11411-3(b)(1).

[284] See Technical Advice Memorandum 201317010 (Jan. 18, 2013), Private Letter Ruling 201029014 (July 23, 2010), Technical Advice Memorandum (Aug. 17, 2007); see also *Frank Aragona Trust*, 142 T.C. No. 9 (2014) (holding that the activities of the trustees constituted material participation); *Mattie K. Carter Trust*, 256 F. Supp. 2d 536 (N.D. Tex. 2003) (holding that in determining material participation for a trust, the activities of its employees and agents should be included with the activities of its trustee).

Application of NII tax to CFCs and PFICs

Special rules apply to taxpayers who own certain foreign corporations. First, U.S. shareholders of controlled foreign corporations ("CFCs") must include currently under sections 951 and 951A certain income earned by the CFC (referred to as "subpart F income" and "global intangible low-taxed income" ("GILTI"), respectively).[285] Second, 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").[286] In certain cases, taxpayers that own stock in a PFIC may elect (under a "qualified electing fund" or "QEF" election) to include currently under section 1293 their pro rata share of the PFIC's ordinary income and long-term capital gain.[287] For taxpayers that own marketable stock in a PFIC, another option is to elect to mark to market their PFIC stock under section 1296.

Absent an election of current NII taxation under the regulations,[288] subpart F and GILTI inclusions in respect of stock of a CFC and QEF inclusions in respect of stock of a PFIC are not net investment income even though those inclusions may be comparable to other items of income that are net investment income. Under the regulations' default rules, only distributions of earnings that have been previously taxed under subpart F, GILTI, or the QEF rules are net investment income. By contrast, mark-to-market inclusions in respect of PFIC stock generally are net investment income even though the inclusions do not result from an actual sale of PFIC stock.[289]

Application of employment taxes and the NII tax to individuals

As described above, the FICA HI tax, the SECA HI tax, and the NII tax each apply up to a 3.8 percent tax rate,[290] but they apply to different categories of taxpayers and to different tax bases. The differences in the application of these taxes mean that some income, including income derived from passthrough businesses, is not subject to a 3.8-percent tax rate under any of the three regimes. Table 6 summarizes the application of each regime for different categories of taxpayers:

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[285] 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 that own at least 10 percent of the stock (measured by vote or value). Secs. 951(b), 957, and 958.

[286] See secs. 1291 through 1298. The PFIC rules generally seek to prevent the deferral of passive income through the use of foreign corporations.

[287] Such a PFIC is referred to as a qualified electing fund ("QEF"). See secs. 1293 and 1295.

[288] Treas. Reg. secs. 1.951A-5(b)(1), 1.1411-10(g).

[289] Treas. Reg. sec. 1.1411-10.

[290] For FICA and SECA, the HI tax rate is 2.9 percent, plus an additional 0.9 percent rate on wages and self-employment income above the threshold amounts ($250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case).

Table 6.–Application of FICA, SECA, and NII Tax Regimes Under Present Law

Type of Taxpayer	FICA	SECA	NII tax	No 3.8% tax
Employees	Wages			
S corporation shareholders - active	Reasonable compensation			Distributive share in excess of reasonable compensation; net gain from sale of business property
General partners		Self-employment income		
LP, LLP, and LLC limited partners or members - active		Guaranteed payments		Distributive share of partners claiming limited partner exception from SECA; net gain from sale of business property
S corporation shareholders; LP, LLP, and LLC limited partners or members - passive			Distributive share; net gain from sale of business property	
Sole proprietors		Self-employment income		
Investors			Investment income and net gain from passive activities or trading businesses	Investment income and net gain from active interests

Description of Proposal

In general, the proposal provides that a high-income individual (determined based on specified, filing-status-based amounts described below) is subject to NII tax on net income or net gain regardless of whether the taxpayer materially participates in a trade or business that generated the net income or net gain, where such net income or net gain is not otherwise subject to FICA or SECA tax in the hands of the taxpayer. A principal effect of the proposal is that those S corporation shareholders, limited partners, and LLC members who currently are not liable for FICA or SECA tax, respectively, on their pro rata shares, distributive shares, and partnership income and gain become subject to NII tax on this income and gain above certain income thresholds.

For taxpayers subject to the proposal, the proposal expands the definition of net investment income subject to the NII tax. Under the proposal, in the case of any individual whose modified AGI exceeds the high income threshold amount, the NII tax of 3.8 percent applies to the greater of specified net income or net investment income (as defined under present law).

Under the proposal, in the case of an estate or trust, the NII tax is 3.8 percent of the lesser of (1) the greater of undistributed specified net income or undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

Specified net income

Specified net income under the proposal includes, among other items described below, income derived in the ordinary course of a trade or business without regard to the present law limitation that the trade or business is a passive activity with respect to the taxpayer or consists of trading financial instruments or commodities. Specified net income is specified income reduced by the deductions properly allocable to such income. Specified income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, (ii) other gross income derived from a trade or business, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property.

Specified net income is determined without regard to the special rules for determining net investment income for income on investment of working capital and for dispositions of a partnership interest or stock in an S corporation.

In determining specified net income, a trade or business includes any activity involving research or experimentation (within the meaning of section 174) and any activity in connection with a trade or business or with respect to which expenses are allowable as a deduction under section 212 (to the extent provided in regulations pursuant to section 469(c)(6)).

Specified net income does not include distributions from a qualified retirement plan. Specified net income does not include amounts subject to SECA tax or wages subject to FICA tax.

Income thresholds and phase-in of increase

The high income threshold amount is $500,000 in the case of a joint return or surviving spouse, $250,000 in the case of a married individual filing a separate return, and $400,000 in any other case.

The increase in tax under the proposal is phased in based on a ratio of (i) the excess of the taxpayer's modified AGI over the applicable high income threshold amount to (ii) $100,000 (one-half of such amount in the case of a married taxpayer filing separately). Under this phase-in, if a married individual who files a joint return has modified adjusted gross income of, for example, $540,000, the increase in tax under the proposal is limited to 40 percent ($540,000 - $500,000 / $100,000) of the increase that would be determined in the absence of the phase-in limitation.

The proposal retains the unindexed threshold amounts above which the NII tax applies, specifically, $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Clarifications regarding net investment income

The proposal provides several clarifications regarding the determination of net investment income, which also apply to determinations of specified net income under the proposal. First, the proposal clarifies that net investment income does not include wages subject to FICA tax.

Second, the proposal clarifies that deductions properly allocable to investment income in determining net investment income do not include net operating loss deductions under section 172.

Finally, the proposal provides that net investment income includes subpart F and GILTI inclusions in respect of stock of a CFC and QEF inclusions in respect of stock of a PFIC. It codifies the existing regulatory treatment of mark-to-market inclusions in respect of PFIC stock as net investment income. The proposal provides that the Secretary shall issue regulations or other guidance providing for the treatment of distributions of amounts previously included in gross income for purposes of chapter 1 but not previously subject to NII tax. The regulations or other guidance shall include transition rules for proper coordination and application of existing inclusion rules with the inclusion rules under the proposal for subpart F and GILTI inclusions in respect of stock of a CFC and inclusions in respect of stock of a PFIC.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

4. Limitation on deduction of qualified business income for certain high income individuals

Present Law[291]

For taxable years beginning after December 31, 2017, and before January 1, 2026, a taxpayer other than a corporation (that is, individuals as well as fiduciaries and beneficiaries of trusts and estates) generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.[292]

The amount deductible may not exceed 20 percent of the taxpayer's taxable income for the taxable year (reduced by net capital gain).[293]

Limitations based on W-2 wages and capital investment phase in above a threshold amount of taxable income.[294] A disallowance of the deduction of income of specified service trades or businesses[295] also phases in above the threshold amount of taxable income. The threshold amount is indexed for inflation for taxable years beginning after 2018. For 2021, the threshold amount is $329,800 for married filing joint returns, $164,925 for married filing separate returns, and $164,900 for all other returns.[296]

For any taxable year, qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the

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[291] The provision, section 199A, as originally enacted in 2017, is described in more detail in Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS-1-18, December 2018, pages 11-38. For a description of changes to section 199A in 2018 (as still in effect), see Joint Committee on Taxation, *General Explanation of Certain Tax Legislation Enacted in the 115th Congress*, JCS-2-19, October 2019, pages 120-139.

[292] Sec. 199A.

[293] Sec. 199A(a). For this purpose, taxable income is computed without regard to the deduction allowable under the provision. Sec. 199A(e)(1).

[294] For a taxpayer with taxable income above the threshold, the taxpayer is allowed a deductible amount for each qualified trade or business equal to the lesser of (1) 20 percent of the qualified business income with respect to such trade or business, or (2) the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property of the qualified trade or business. Sec. 199A(b)(2).

[295] A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Sec. 199A(d)(2).

[296] Sec. 3.27 of Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

taxpayer.[297] The determination of qualified items of income, gain, deduction, and loss takes into account such items only to the extent included or allowed in the determination of taxable income for the year.[298] Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.[299]

A specified agricultural or horticulture cooperative generally may deduct nine percent of the lesser of the cooperative's qualified production activities income or taxable income (determined without regard to the cooperative's section 199A deduction and reduced by certain payments or allocations to patrons) for the taxable year.[300]

Description of Proposal

The proposal adds a dollar limitation on the deduction for qualified business income under section 199A(a) for a taxable year. In the case of a taxpayer other than a corporation, the amount of the deduction for any taxable year may not exceed $500,000 for a joint return or surviving spouse, $250,000 for a married individual filing a separate return, $10,000 for an estate or trust, or $400,000 for any other taxpayer. The present-law phaseouts of the deduction above the threshold amount continue to apply, subject to this additional limitation.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

5. Limitations on excess business losses of noncorporate taxpayers

Present Law

For taxable years beginning after December 31, 2020, and before January 1, 2027, an excess business loss of a taxpayer other than a corporation is not allowed for the taxable year.[301]

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[297] Qualified business income does not include any qualified REIT dividends or qualified publicly traded partnership income. Sec. 199A(c)(1).

[298] Certain items are not qualified items of income, gain, deduction, or loss. Sec. 199A(c)(3)(B).

[299] For this purpose, section 864(c) is applied by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation," each place they appear. Sec. 199A(c)(3)(A).

[300] Sec. 199A(g). The deduction is limited to 50 percent of W-2 wages that are paid by the cooperative during the calendar year that ends in such taxable year and are properly allocable to domestic production gross receipts. The deduction may instead be allocated to and deducted by the cooperative's patrons, limited to each patron's taxable income for the taxable year (determined without regard to such deduction but after taking into account the patron's other deductions under section 199A(a)). See sec. 199A(g).

[301] Sec. 461(l).

The disallowed excess business loss is treated as a net operating loss ("NOL") for the taxable year for purposes of determining any NOL carryover for subsequent taxable years.[302]

An excess business loss for the taxable year is the excess (if any) of the aggregate deductions of the taxpayer which are attributable to trades or businesses of such taxpayer, over the sum of the aggregate gross income or gain of such taxpayer attributable to such trades or businesses plus a threshold amount.[303] The threshold amount is indexed for inflation for taxable years beginning after 2018.[304] For 2021, the threshold amount is $262,000 ($524,000 for joint returns).[305]

The aggregate deductions taken into account to determine the excess business loss of the taxpayer for the taxable year that are attributable to trades or businesses of the taxpayer are determined without regard to the limitation of the provision, and without regard to any deduction under section 172 (relating to NOLs) or 199A (relating to the deduction for qualified business income). For example, assume that a taxpayer has an NOL carryover from a prior taxable year to the current taxable year. Such NOL carryover is not part of the taxpayer's aggregate deductions attributable to the trade or business for the current taxable year under section 461(l).

An excess business loss (the deduction for which is limited by section 461(l)) does not take into account gross income or gains or deductions attributable to the trade or business of performance of services as an employee.[306] For example, assume married taxpayers filing jointly for the taxable year have a loss from a trade or business conducted by one spouse as a sole proprietorship as well as wage income of the other spouse from employment. The wage income is not taken into account in determining the amount of the deduction limited under section 461(l).

Capital loss deductions are not taken into account in computing the section 461(l) limitation.[307] The amount of capital gain taken into account in calculating the section 461(l) limitation cannot exceed the lesser of capital gain net income from a trade or business or capital gain net income.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level.[308] Each partner's distributive share and each S corporation shareholder's pro

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[302] See sec. 172.

[303] Sec. 461(l)(3)(A).

[304] Sec. 461(l)(3)(C).

[305] See sec. 3.32 of Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

[306] For this purpose, the trade or business of performance of services by the taxpayer as an employee has the same meaning as it does under section 62(a)(1).

[307] Sec. 461(l)(3)(B).

[308] Sec. 461(l)(4).

rata share of items of income, gain, deduction, or loss of a partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder. Regulatory authority is provided to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.[309]

Section 461(l) applies after the application of certain other limitations on losses, namely, the passive activity loss limitation,[310] the at-risk limitation,[311] and in the case of a taxpayer who is a partner or S corporation shareholder, the rules limiting the taxpayer's distributive or pro rata share of loss for the taxable year to the taxpayer's adjusted basis in the partnership interest or in the S corporation stock and debt.[312]

For taxable years beginning after December 31, 2017, and before January 1, 2027, the limitation relating to excess farm losses under section 461(j) does not apply.

Description of Proposal

The proposal makes permanent the limitation on any excess business loss of a taxpayer other than a corporation.

The proposal also repeals the limitation on excess farm losses under section 461(j).

The proposal modifies the treatment of an excess business loss disallowed for a taxable year. Any such loss that is disallowed for a particular year is carried forward to the next taxable year and treated as a deduction attributable to trades or businesses of the taxpayer in that year. Thus, in lieu of being carried forward as an NOL carryover, such loss is taken into account as part of the aggregate deductions under section 461(l) for the next taxable year (and therefore may be subject to the excess business loss limitation in that year).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2020.

6. Surcharge on high income individuals, estates, and trusts

Present Law

To determine regular income tax liability, an individual, estate, or trust applies a tax rate schedule to the individual's, estate's, or trust's taxable income. There are different tax rate

[309] Sec. 461(l)(5).

[310] Sec. 469.

[311] Sec. 465.

[312] Sec. 704(d) (for partners) and sec. 1366(d) (for S corporation shareholders). See sec. 461(l)(6) (applying section 461(l) after section 469), and Treas. Reg. sec. 1.469-2T(d)(6) (applying section 469 after sections 704(d), 1366(d), and 465). Note that other rules could potentially limit a taxpayer's loss (*e.g.*, section 267). A discussion of all potential loss limitation rules is beyond the scope of the description of this provision.

schedules for estates and trusts, single individuals, heads of households, married individuals filing joint returns and surviving spouses, and married individuals filing separate returns. Each tax rate schedule is divided into ranges of income referred to as income brackets, and marginal income tax rates increase with increasing income brackets.

The highest marginal income tax rate applicable to individuals, estates, and trusts is 37 percent. For taxable years beginning after December 31, 2021, the bill increases the highest rate to 39.6 percent and decreases the taxable income thresholds at which the highest rate applies. For example, under present law in 2022 for married individuals filing a joint return, the 37 percent rate is projected to apply to taxable income in excess of $646,150.[313] In 2022 for married individuals filing a joint return, the bill's 39.6 percent rate applies to taxable income in excess of $450,000.

There is no separate income tax surcharge applicable to taxpayers with income above certain levels.

Description of Proposal

The proposal imposes (in addition to any other tax imposed by Subtitle A of the Code) a three-percent tax on the modified adjusted gross income of an individual, estate, or trust that exceeds a prescribed amount.

For single individuals, heads of households, married individuals filing joint returns and surviving spouses, the three-percent tax applies to modified adjusted gross income in excess of $5 million. For married individuals filing separate returns, the three-percent tax applies to modified adjusted gross income in excess of $2.5 million. For estates or trusts, the three-percent tax applies to modified adjusted gross income that exceeds $100,000.

For purposes of the three-percent tax, modified adjusted gross income is adjusted gross income reduced by any deduction (not taken into account in determining adjusted gross income) allowed for investment interest (as defined in section 163(d)). For this purpose, adjusted gross income of an estate or a trust is determined under the rules of section 67(e).

The amount of the three-percent tax imposed on a nonresident alien individual is determined by taking into account only amounts that are taken into account in determining the individual's section 1 net income tax liability under section 871(b) (that is, only income that is effectively connected with the conduct of a U.S. trade or business, and the deductions allocable to that income).

The $5 million and $2.5 million modified adjusted gross income thresholds at which the three-percent tax applies are reduced by any amounts excluded from a taxpayer's gross income under the foreign earned income and housing cost amount rules of section 911, less any deductions or exclusions properly allocable to amounts excluded under section 911.

[313] Joint Committee staff calculation.

The three-percent tax does not apply to a trust if all the unexpired interests in the trust are devoted to one or more purposes described in section 170(c)(2)(B) (among other things, religious, charitable, scientific, literary, or educational purposes).

The three-percent tax is not treated as tax imposed by Subtitle A (Income Taxes), Chapter 1 (Normal taxes and Surtaxes) of the Code for purposes of determining the amount of any Chapter 1 credit or for purposes of the alternative minimum tax.

Effective Date

The proposal applies to taxable years beginning after December 31, 2021.

7. Termination of temporary increase in unified credit

Present Law

In general

A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (*i.e.*, a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Income tax rules determine the recipient's tax basis in property acquired from a decedent or by gift. Gifts and bequests generally are excluded from the recipient's gross income.[314]

Unified credit (exemption) and tax rates

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death.[315] The unified credit offsets tax, computed using the applicable estate and gift tax rates, on a specified amount of transfers, referred to as the applicable exclusion amount, or exemption amount. Exemption used during life to offset taxable gifts reduces the amount of exemption that remains at death to offset the value of a decedent's estate. An election is available under which exemption that is not used by a decedent may be used by the decedent's surviving spouse (exemption portability).

For decedents dying and gifts made before January 1, 2018, the basic exclusion amount that is used to determine the unified credit is $5 million, indexed for inflation for decedents dying and gifts made after 2011. The basic exclusion amount temporarily increases for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is

[314] Sec. 102.

[315] Sec. 2010.

accomplished by doubling the basic exclusion amount provided in section 2010(c)(3) of the Code from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011. For 2021, the basic exclusion amount is $11,700,000.[316]

The temporary increase in the basic exclusion amount expires for decedents dying and gifts made after December 31, 2025. At that time, the basic exclusion amount returns to $5 million, indexed for inflation occurring after 2011.

Common tax rate table

A common tax-rate table with a top marginal tax rate of 40 percent is used to compute gift tax and estate tax. The 40-percent rate applies to taxable transfers in excess of $1 million. Because the 2021 exemption amount ($11.7 million) is greater than this $1 million threshold at which the highest marginal tax rate applies, transfers in excess of the exemption amount generally are subject to tax at the 40 percent rate.

Generation-skipping transfer tax exemption and rate

The generation-skipping transfer tax is a separate tax that can apply in addition to either the gift tax or the estate tax. The tax rate and exemption amount for generation-skipping transfer tax purposes, however, are set by reference to the estate tax rules. Generation-skipping transfer tax is imposed at a flat rate equal to the highest estate tax rate (40 percent) in effect at the time of the transfer. Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption for a given year is equal to the estate tax exemption amount in effect for that year ($11.7 million for 2021).

Description of Proposal

The proposal accelerates the expiration of the temporary increase in the estate and gift tax exemption amount. As a result, for decedents dying and gifts made after December 31, 2021, the basic exclusion amount is determined by increasing $5 million for inflation occurring after

[316] Rev. Proc. 2020-45, 2020-46 I.R.B. 1016, p. 1024 (November 9, 2020). As a conforming amendment to the increase in the basic exclusion amount, Public Law 115-97 also amends section 2001(g) (regarding computation of estate tax). This conforming amendment, which was enacted as a permanent provision, provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of section 2001 with respect to differences between the basic exclusion amount in effect at the time of the decedent's death and at the time of any gifts made by the decedent. The purpose of the regulatory authority is to address the computation of the estate tax where (1) a decedent dies in a year in which the basic exclusion amount is lower than the basic exclusion amount that was in effect when the decedent made taxable gifts during his or her life, and (2) such taxable gifts exceeded the basic exclusion amount in effect at the time of the decedent's death. Because the temporary increase in the basic exclusion amount under Public Law 115-97 does not apply for estates of decedents dying after December 31, 2025, it was expected that such guidance would prevent the estate tax computation under section 2001(g) from recapturing, or "clawing back," all or a portion of the benefit of the increased basic exclusion amount used to offset gift tax for certain decedents who make large taxable gifts between January 1, 2018, and December 31, 2025, and die after December 31, 2025. In November 2019, the IRS published final regulations pursuant to this regulatory authority. See Treasury Decision 9884 (November 26, 2019).

2011). The Joint Committee staff currently estimates that the basic exclusion amount under the proposal would be $6,020,000 for 2022.

Effective Date

The proposal is effective for estates of decedents dying and gifts made after December 31, 2021.

8. Increase in limitation on estate tax valuation reduction for certain real property used in farming or other trades of businesses

Present Law

An executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying trade or business at its current-use value rather than its fair market value.[317] The inflation-adjusted maximum reduction in value for such real property is $1,190,000 for 2021.[318] In general, real property qualifies for special-use valuation only if (1) at least 50 percent of the adjusted value of the decedent's gross estate (including both real and personal property) consists of a farm or closely-held business property and (2) at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (for example, farming) by the decedent or a member of the decedent's family for periods aggregating five years or more of during the eight-year period ending on the date of the decedent's death.

If, within 10 years after the decedent's death and before the death of the qualified heir, the heir disposes of an interest in the property or ceases to use the property in its qualified use, an additional estate tax is imposed to recapture the benefit of the special-use valuation.[319]

Description of Proposal

The proposal increases the maximum reduction in value for qualified real property under section 2032A to $11,700,000, indexed for inflation for years after 2021.

Effective Date

The proposal is effective for estates of decedents dying after December 31, 2021.

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[317] Sec. 2032A.

[318] Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024. Section 2032A(a) provides for a maximum reduction in value of $750,000, with this amount being adjusted for inflation for years after 1997.

[319] Sec. 2032A(c).

9. Certain tax rules applicable to grantor trusts

Present Law

Grantor trusts, in general

A trust is a grantor trust if the grantor or another individual is treated as the owner of all or a portion of the trust for Federal income tax purposes. An individual who is treated as the owner of all or a portion of a grantor trust must include in computing his or her taxable income and credits those items of income, deductions, and credits against tax of the trust that are attributable to the portion of the trust deemed owned by such individual.[320]

In general, a trust with respect to which a grantor has retained a right or benefit described in sections 673 through 679 is treated as a grantor trust. A grantor generally is treated as the owner of a trust for Federal income tax purposes if, for example: she has a reversionary interest in the income or corpus of the trust; she or a non-adverse party has the power to revoke the trust; or she (without the approval or consent of an adverse party) has the power to distribute trust income to herself or to her spouse.[321] As another example, if a U.S. person transfers property to a foreign trust that has a U.S. beneficiary, the grantor trust rules generally treat the transferor as the owner of a portion of the trust for Federal income tax purposes.[322] A grantor's retention of certain administrative powers also may cause a trust to be treated as a grantor trust.[323] For example, a grantor's power to borrow from the corpus or income of the trust without adequate interest or security, or a grantor's power to reacquire the trust corpus and substitute property of equivalent value, may cause the trust to be treated as a grantor trust.[324] In some cases, a person other than the grantor may be treated as deemed owner.[325]

Because a grantor trust and its grantor are treated as one taxpayer for Federal income tax purposes, the IRS has taken the position that transactions between the grantor and the trust generally are disregarded for Federal income tax purposes.[326] In Revenue Ruling 85-13,[327] for example, the IRS concludes that a grantor's acquisition of the corpus of a grantor trust (shares of stock) in exchange for a promissory note is not a sale for Federal income tax purposes, because the grantor is treated as the owner of the shares both before and after the sale. As a result, a

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[320] Sec. 671.

[321] Secs. 673(a), 676(a), and 677(a)(1).

[322] Sec. 679.

[323] Sec. 675.

[324] Secs. 675(2) & (4)(C).

[325] Sec. 678.

[326] *Cf. Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).

[327] 1985-1 C.B. 184, 1985.

grantor's acquisition of assets from a grantor trust generally does not result in recognition of gain or loss, and the payment of interest by the trust to the grantor generally does not result in income to the grantor. Similarly, a grantor generally does not realize or recognize gain or loss for Federal income tax purposes on the transfer of appreciated or depreciated assets to the trust.

The IRS also takes the position that the grantor's payment of the income taxes of a grantor trust is not treated as an additional gift to the trust beneficiaries for Federal gift tax purposes, because the grantor is obligated to pay the income tax of the trust.[328]

Federal estate and gift tax treatment of certain transfers in trust

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. For Federal gift tax purposes, a transfer to a trust generally is treated as a gift to the beneficiaries of the trust.[329]

In certain cases, lifetime transfers that are treated as completed transfers for gift tax purposes and thus are subject to gift tax in the year of the transfer nevertheless are included in the transferor's gross estate for Federal estate tax purposes at the time of his or her death.[330] These transfers generally include transfers for less than adequate and full consideration if: (1) the decedent retained the beneficial enjoyment of the property during his or her life;[331] (2) the decedent retained the power to alter, amend, revoke, or terminate a previous lifetime transfer;[332] (3) the decedent held an interest in such property within three years of death;[333] or (4) the transfer takes effect at the death of the decedent.[334]

Intentionally defective grantor trusts ("IDGTs")

As an estate planning technique, taxpayers sometimes structure trusts that are treated as separate from the grantor for Federal transfer tax purposes, but as owned by the grantor for Federal income tax purposes. Such trusts sometimes are referred to as intentionally defective grantor trusts ("IDGTs"), because the taxpayer intentionally includes in the trust agreement a right or power that causes the trust to be treated as a grantor trust under sections 671 through 679.

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[328] Rev. Rul. 2004-64, 2004-2 C.B. 7, 2004.

[329] *Helvering v. Hutchings*, 312 U.S. 393, 396-397 (1941).

[330] See secs. 2035-2038.

[331] Sec. 2036.

[332] Sec. 2038.

[333] Sec. 2035.

[334] Sec. 2037.

Certain rights or powers that result in grantor trust status, however, may not cause the assets of the trust to be included in the grantor's estate for Federal estate tax purposes. In other words, a transfer may, under certain circumstances, be treated as a completed transfer for Federal gift tax purposes, but not for income tax purposes. For example, in certain circumstances a grantor might retain an administrative power that causes the trust to be treated as a grantor trust, such as the power to reacquire the corpus of a trust and to substitute assets of equivalent value under section 675(4)(C), without causing the assets of the trust to be included in the grantor's gross estate under sections 2036 through 2038.

An example of transfer tax planning using IDGTs is an estate "freeze" transaction. In a simple estate freeze transaction, a grantor might transfer assets to such an IDGT by way of a taxable gift during his or her lifetime. The gift tax value is measured ("frozen") at the time of the transfer, and any subsequent appreciation accrues to the trust (and ultimately the trust beneficiaries) without further gift or estate tax consequences, provided the trust is structured to avoid inclusion in the grantor's gross estate. Furthermore, as the deemed owner of the trust assets for income tax purposes, the grantor may satisfy the income tax liability of the trust out of the grantor's separate assets, thereby preserving trust assets for the beneficiaries, without being treated as having made additional taxable gifts to the trust beneficiaries by reason of the tax payments. Finally, any transactions between the grantor and the trust (such as the grantor's reacquisition of the trust corpus) are disregarded for Federal income tax purposes. Because grantors in these estate "freeze" structures often have annuity interests in trust assets, the trusts in these structures are commonly referred to as grantor retained annuity trusts.

Description of Proposal

Application of transfer taxes to certain grantor trusts

The proposal generally is intended to more closely align the income tax and transfer tax (Federal estate and gift tax) rules for grantor trusts by imposing transfer tax consequences on certain assets held in or distributed from a grantor trust. For any portion of a trust with respect to which the grantor is the deemed owner: (1) the gross estate of a deceased deemed owner of such portion includes all assets attributable to that portion at the time of the deemed owner's death; (2) any distribution (other than to a deemed owner or the deemed owner's spouse) from such portion to one or more beneficiaries during the life of the deemed owner of such portion, other than in discharge of an obligation of the deemed owner, is treated as a transfer by gift for gift tax purposes; and (3) if during life the deemed owner ceases to be treated as the deemed owner of such portion, all assets attributable to such portion are treated as having been transferred by gift for gift tax purposes at such time. Proper adjustment must be made for any amounts included in the gross estate or treated as transferred by gift under (1), (2), or (3) to account for amounts treated previously as taxable gifts at the time the deemed owner transferred assets to the trust.

For purposes of the proposal, a "deemed owner" is any person who is treated as owner of a portion of a trust under the grantor trust rules (sections 671 through 679 of the Code). The proposal does not apply to any trust that is includible in the gross estate of the deemed owner (without regard to the proposal).

Certain sales to grantor trusts

In the case of any transfer or property between a trust and a person (whether or not the grantor) who is a deemed owner[335] of the trust (or portion thereof), the proposal provides that the person's treatment as the owner of the trust is disregarded in determining whether there is a sale or exchange for income tax purposes. As a result, such a transfer might result in the realization and recognition of gain.[336] This rule does not apply to any trust that is fully revocable by the deemed owner.

The proposal amends section 267, which disallows certain losses on sales and exchanges between persons with a relationship described in subsection 267(b), to add as one such relationship a grantor trust and the person treated as the owner of the trust (or portion thereof) under the grantor trust rules.

Effective Date

The proposal is effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date.

10. Valuation rules for certain transfers of nonbusiness assets

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.[337] The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[338]

If actual sales prices and bona fide bid and ask prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook overall and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by

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335 For purposes of this rule, the term "deemed owner" has the meaning described above.

336 The proposal thus changes the nonrecognition rule stated in Rev. Rul. 85-13, 1985 C.B. 184, described above.

337 Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternate valuation date if the executor so elects) in the case of the estate tax.

338 Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.[339]

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of stock held by a 50-percent shareholder might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts claimed under present law are described below.[340] In many cases courts apply more than one discount. The theories for some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely-held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.[341] Minority discounts arise from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its

[339] Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237, 1959.

[340] Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities)* discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

[341] See Rev. Rul. 93-12, 1993-2 C.B. 202, 1993; *Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner,* 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner,* 40 T.C. 100 (1963).

In *Pierre v. Commissioner*, 133 T.C. 2 (2009), the Tax Court allowed minority and marketability discounts in valuing transfers of interests in a single member LLC to trusts established for the transferor's children. The taxpayer had funded the LLC with cash and marketable securities 12 days before she transferred the LLC interests to the trusts. Although the LLC was treated as a disregarded entity for Federal tax purposes under the "check-the-box" regulations, the court rejected the Service's argument that the taxpayer should be treated as having transferred for Federal gift tax purposes a proportionate share of the underlying assets of the LLC and thus should not be entitled to claim valuation discounts. The court reasoned that State law controlled the determination of what property interests were transferred for Federal transfer tax purposes; under State law, the LLC was a separate legal entity, and the taxpayer did not have a property interest in the underlying assets of the LLC. In its opinion, the court noted that "Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically."

owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.[342]

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests may be less attractive to investors and may have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,[343] but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.[344] Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases. However, the discount has been applied to a 100-percent ownership interest in a closely-held corporation.[345] Marketability discounts often result in reductions in the value of transferred property of 20 to 30 percent[346] in addition to any applicable minority discount.[347] Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts claimed through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

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[342] See David T. Lewis and Andrea Chomakos, *The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities*, ABA Publishing, 2004, p. 11.

[343] *E.g.*, *Central Trust Co. v. United States*, 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner*, T.C. Memo 1989-466.

[344] Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

[345] See, *e.g.*, *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. ("Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.").

[346] There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, *i.e.*, converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

[347] The Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (*e.g.*, a gift of an undivided fractional interest in real estate).[348] Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.[349]

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts may overlap with the marketability discount.[350]

Description of Proposal

For estate and gift tax purposes, the proposal disallows the use of valuation discounts in valuing certain transfers of nonbusiness assets. In the case of the transfer of any interest in an entity other than an interest which is actively traded,[351] the value of any nonbusiness assets held by the entity with respect to such interest are determined as if the transferor had transferred such assets directly to the transferee, and no valuation discount is allowed with respect to such nonbusiness assets. The value of such nonbusiness assets is disregarded when determining the value of the interest in the entity.

The term "nonbusiness asset" means any passive asset held for the production or collection of income that is not used in the active conduct of a trade or business. For this purpose, a passive asset is not treated as used in the active conduct of a trade or business unless the asset is: (a) generally, inventory property or accounts or notes receivable,[352] or a hedge with respect to such property; or (b) real property used in the active conduct of one or more real

[348] Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, 2d ed., 1993, para. 135.3.4. Courts, however, often apply a minority discount instead. See, *e.g.*, *LeFrak v. Commissioner*, T.C. Memo 1993-526.

[349] See, *e.g.*, *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

[350] For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

[351] The term "actively traded" is defined by reference to section 1092. The regulations under section 1092 generally define the term to mean property for which there is an established financial market. See Treas. Reg. sec. 1.1092(d)-1(a).

[352] More specifically, the provision references property described in section 1221(a)(1) ("stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business") and 1221(a)(4) ("accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1)").

property trades or businesses[353] in which the transferor materially participates and with respect to which the transferor meets an hours-based requirement.[354] Material participation is determined under the rules of section 469(h),[355] which generally require that the taxpayer be involved in the operations of the activity on a basis that is regular, continuous, and substantial. Notwithstanding the general rule stated above, a passive asset that is held as part of the reasonably required working capital needs of a trade or business is treated as used in the active conduct of a trade or business.

The term "passive asset" means any:

- Cash or cash equivalents;
- Except to the extent provided by the Secretary, stock in a corporation or any other equity, profits, or capital interest in a partnership;
- Evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative;
- Foreign currency;[356] interest in a real estate investment trust, common trust fund, regulated investment company, or publicly traded partnership;[357] or interest in a precious metal;[358]
- Annuity;
- Real property;
- Asset (other than a patent, trademark, or copyright) which produces royalty income;
- Commodity;

[353] The term "real property trade or business" has the meaning given the term under section 469(c)(7)(C) ("any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business").

[354] See sec. 469(c)(7)(B)(ii) (requiring that the taxpayer perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates).

[355] For this purpose, the material participation standards of section 469(h) area apply without regard to the limitation to farming activity in section 469(h)(3).

[356] Sec. 351(e)(1)(B)(iii).

[357] As described in section 351(e)(1)(B)(iv), including any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in this clause (*i.e.*, an interest in a real estate investment trust, common trust fund, regulated investment company, or publicly traded partnership), an interest in a precious metal, or any other asset prescribed by the Secretary in regulations.

[358] As described in section 351(e)(1)(B)(v).

- Collectible;[359]
- Personal property[360] or position in personal property;[361] or
- Other asset specified in regulations prescribed by the Secretary.

The proposal includes a look-through rule that applies if a passive asset of an entity consists of a 10-percent interest in another entity. In such cases, the valuation rules of the proposal are applied by disregarding the 10-percent interest and by treating the entity as holding directly its ratable share of the assets of the other entity. This rule is applied successively to any 10-percent interest of such other entity in any other entity. The term "10-percent interest" means: (a) ownership of at least 10 percent (by vote or value) of the stock of a corporation; (b) ownership of at least 10 percent of the capital or profits interest in a partnership; and (c) ownership of at least 10 percent of the beneficial interests in any other entity. For purposes of the definition of a 10-percent interest, the ownership attribution rules of section 318 apply.[362] Thus, for example, if a transferor is transferring an interest in Entity 1, which has an 8 percent interest in Entity 2, and transferor separately has a direct 5 percent interest in Entity 2, the look-through rule applies.

The proposal directs the Secretary to issue such regulations or other guidance as is necessary or appropriate to carry out the proposal, including regulations or other guidance to: (1) determine whether a passive asset is used in the active conduct of a trade or business; and (2) determine whether a passive asset is held as part of the reasonably required working capital needs of a trade or business.[363]

Effective Date

The proposal is effective for transfers after the date of enactment.

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[359] Within the meaning of section 408(m) (*i.e.*, any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or other tangible personal property specified in regulations).

[360] As defined in section 1092(d)(1) ("property of a type which is actively traded").

[361] Within the meaning of section 1092(d)(2) ("an interest (including a futures or forward contract or option) in personal property").

[362] Section 318 includes rules for constructive ownership of stock that generally apply for determining whether a redemption of stock is treated as a sale or exchange. These rules, in some cases, treat the shareholder as owning stock that is in fact owned by another person, such as a family member or an entity or trust. For example, an individual generally is treated as owning stock owned directly or indirectly by his or her spouse, children, grandchildren, or parents. Sec. 318(a)(1). Certain stock owned directly or indirectly by a partnership, estate, trust, or corporation is treated as owned by the partners, beneficiaries (or a deemed owner in the case of a grantor trust), or shareholders. Sec. 318(a)(2). A partnership, estate, trust, or corporation is treated as owning certain stock owned directly or indirectly by partners, beneficiaries (or a deemed owner in the case of a grantor trust), or shareholders. Sec. 318(a)(3). A person who has an option to acquire stock is treated as owning the stock. Sec. 318(a)(4).

[363] Subsection 2031(b) (relating to the valuation of unlisted stock and securities for purposes of determining the value of a decedent's gross estate) is to be applied after the valuation rules of the proposal.

G. Contribution Limit for Individual Retirement Plans of High-Income Taxpayers with Large Account Balances and Increase in Minimum Required Distributions for High-Income Taxpayers with Large Retirement Account Balances

Present Law

In general

An individual retirement arrangement ("IRA") is a tax-favored savings arrangement under which retirement savings are held in a tax-exempt trust or custodial account (or annuity contract) until distributed. There are two basic types of IRAs under present law: traditional IRAs,[364] to which both deductible and nondeductible contributions may be made,[365] and Roth IRAs, to which only nondeductible contributions may be made.[366] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, and distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) and, if certain requirements are satisfied, distributions are not includible in gross income.

Tax-favored treatment applies also to certain employer-sponsored retirement plans, including qualified retirement plans and annuities,[367] tax-deferred annuities,[368] governmental eligible deferred compensation plans,[369] SIMPLE (savings incentive match plan for employees) individual retirement arrangements ("IRAs"),[370] and simplified employee pensions ("SEPs").[371] A qualified defined contribution plan may include a qualified cash-or-deferred arrangement ("section 401(k) plan"), under which a participant may make pretax elective deferrals. Section 403(b) plans and governmental section 457(b) plans also generally provide for pretax elective deferrals. These plans may also provide for pretax employer contributions that are not elective deferrals. The distinction between traditional accounts (or also called pretax accounts)

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[364] Sec. 408. IRAs include individual retirement accounts under section 408(a) and individual retirement annuities under section 408(b).

[365] Sec. 219.

[366] Sec. 408A.

[367] Secs. 401(a) and 403(a).

[368] Sec. 403(b).

[369] Sec. 457(b). Section 401(k) provides rules for a cash-or-deferred arrangement.

[370] Sec. 408(p).

[371] Sec. 408(k).

and Roth accounts also exists for amounts held in individual accounts under these tax-favored employer-sponsored retirement plans with a qualified Roth contribution program.[372]

Accumulations or aggregate account balances in IRAs (both traditional and Roth IRAs) include both regular IRA contributions and rollover contributions from tax-favored employer-sponsored retirement plans and other IRAs. As discussed in more detail below, the amount (and attributable earnings) held in Roth IRAs may consist of not only amounts originally contributed to Roth accounts (Roth IRAs or designated Roth accounts under employer-sponsored plans) as Roth contributions, but also amounts originally contributed to traditional or pretax accounts and then subsequently converted to Roth accounts.

An individual may receive an interest in a traditional or Roth IRA as a result of a transfer from a spouse or former spouse under a divorce or separation instrument.[373] Such a transfer is not taxable for the transferring spouse, and the resulting IRA is considered to be the IRA of the recipient spouse maintained for his or her benefit. An individual may also become the beneficiary of a traditional or Roth IRA after the death of the original IRA owner.[374] In some respects, an IRA inherited by a beneficiary other than the IRA's surviving spouse are subject to more restrictive rules than other IRAs. If the spouse of the original IRA owner inherits the IRA, the spouse may treat the IRA as his or her own IRA, rather than as an inherited IRA.

Limits on regular annual IRA contributions

Annual contribution limit

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of (1) a certain dollar amount ($6,000 for 2021) plus $1,000 for an individual who has attained age 50 before the end of the taxable year or (2) the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. In addition, deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs generally are subject to adjusted gross income ("AGI") limits. IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels. In the case of an individual who is an

[372] Section 402A describes a qualified Roth contribution program.

[373] Sec. 408(d)(6).

[374] Sec. 408(d)(3)(C).

active participant in an employer-sponsored plan, the AGI phase-out ranges for 2021 are: (1) for single taxpayers, $66,000 to $76,000; (2) for married taxpayers filing joint returns, $105,000 to $125,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2021 between $198,000 and $208,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2021 are: (1) for single taxpayers, $125,000 to $140,000; (2) for married taxpayers filing joint returns, $198,000 to $208,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

Excise tax on excess contributions

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.[375] This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.[376]

Taxation of distributions from traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis.[377] All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all of the individual's traditional IRAs.

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[375] Sec. 4973(a), (b) and (f).

[376] Sec. 408(d)(4). To receive this treatment for a contribution to a traditional IRA, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

[377] Basis results from after-tax contributions to the IRA or a rollover to the IRA of after-tax amounts from another eligible retirement plan.

Taxation of Roth IRA distributions

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are aggregated for purposes of determining the amount that is a return of contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled over from other Roth IRAs); (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

The Code imposes an early distribution tax on distributions made from Roth IRAs before the earlier of when the Roth IRA owner attains age 59½, becomes disabled, or dies unless an exception applies.[378] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution.

Distributions from Roth IRAs are permitted to be rolled over tax-free to another Roth IRA. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover").[379] Distributions from an inherited IRA (except in the case of an IRA acquired by the surviving spouse by reason of the IRA owner's death) and required minimum distributions are not permitted to be rolled over.[380]

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[378] Sec. 72(t). The tax also applies to early distributions made from qualified retirement plans, section 403(b) plans and traditional IRAs. The early distribution tax does not apply to distributions from governmental section 457(b) plans.

[379] Distributions from other IRAs will generally be included in income and taxed as ordinary income and may also be subject to the 10% early distribution tax (unless rolled over within 60 days), depending on the age of the individual taking the IRA distribution and the purpose for which they will be using the distribution.

[380] A trustee to trustee transfer between IRAs is not treated as a distribution and rollover. Thus, nonspouse beneficiaries of IRAs can move funds to another inherited IRA established as a beneficiary of the decedent IRA owner. In contrast, a surviving spouse is permitted to roll over a distribution to his or her own IRA.

Separation of traditional and Roth IRA accounts and Roth conversions

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents.

Taxpayers generally may convert any amount in a traditional IRA into an amount in a Roth IRA through a distribution from the traditional IRA and rollover to a Roth IRA (either a direct payment or a 60-day rollover).[381] The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that the 10-percent early distribution tax does not apply. However, the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

Rollovers from employer-sponsored plans to Roth IRAs

A distribution from a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to another such plan or an IRA (including to a Roth IRA).[382] The rollover generally can be achieved by direct rollover or 60-day rollover. Amounts that are rolled over are usually not included in gross income.

Distributions from designated Roth accounts may be rolled over tax-free to a Roth IRA. Other distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans also may be rolled into a Roth IRA. However, under the Roth IRA conversion rules, distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account must be included in gross income to the extent required if not rolled over.[383]

Required minimum distributions

Distributions from traditional IRAs and employer-sponsored retirement plans are generally required to begin at attainment of age 72 and to be made in certain minimum amounts

[381] Sec. 408A(d)(3). A conversion can also be achieved by simply redesignating the traditional IRA as a Roth IRA if the entire balance in the account is converted.

[382] Under section 402(c)(4), any distribution of all or any portion of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions. Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k).

[383] Sec. 408A(d)(3).

("required minimum distributions").[384] Under present law, the requirement to begin distributions at attainment of age 72 does not apply to Roth IRAs.[385]

The Code imposes an excise tax on an individual if the amount distributed to an individual during a taxable year is less than the required minimum distribution under the plan for that year.[386] The excise tax is equal to 50 percent of the shortfall (that is, 50 percent of the amount by which the required minimum distribution exceeds the actual distribution). However, the Secretary may waive the tax if the individual establishes that the shortfall was due to reasonable error and reasonable steps are taken to remedy the error.

Description of Proposal

Dollar and income limit for IRAs of high-income taxpayers

Under the proposal, a $10,000,000 limit ("applicable dollar amount") is provided with respect to aggregate accumulations in applicable retirement accounts of certain high-income taxpayers ("applicable taxpayers").[387] An applicable taxpayer is a taxpayer whose adjusted taxable income for a taxable year[388] exceeds: (1) $450,000 in the case of a taxpayer who is a married individual filing a joint return or a surviving spouse;[389] (2) $425,000 in the case of a taxpayer who is a head of household;[390] and (3) $400,000 for a taxpayer not described in (1) or (2). An applicable retirement plan includes a qualified defined contribution plan or annuity,[391] a tax-deferred annuity,[392] a governmental eligible deferred compensation plan,[393] or an IRA.[394] The $10,000,000 applicable dollar amount as well as the adjusted taxable income amounts are increased for cost-of-living adjustments for taxable years beginning in 2023 or later, with adjustments for the accumulation limit being rounded to the next lowest multiple of $250,000

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[384] Secs. 401(a)(9) and 408(a)(6) and (b)(3).

[385] Sec. 408A(c)(4).

[386] Sec. 4974.

[387] The proposal is added to new section 409B.

[388] Adjusted taxable income means taxable income determined without regard to (1) any deduction for annual additions to individual retirement plans to which section 409B(a) applies, and (2) any increase in minimum required distributions by reason of section 4974(e) (as added by this proposal).

[389] As defined in section 2(a).

[390] As defined in section 2(b).

[391] As defined in section 401(a) or 403(a).

[392] As defined in section 403(b).

[393] As defined in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A).

[394] As defined in sections 408 and 408A.

and adjustments for the adjusted taxable income being rounded to the next lowest multiple of $1,000.

In applying the applicable dollar limit for a taxable year, an individual's aggregate vested account balances in all applicable retirement plans maintained on behalf of the individual (whether as a participant, owner, or beneficiary), determined as of the close of the calendar year preceding the calendar year in which the taxable year begins ("prior year aggregate applicable retirement plan balances"), are compared to the individual's applicable dollar amount.

Contribution limit on individual retirement plans of high-income taxpayers with large account balances

The proposal provides that in the case of an individual who is an applicable taxpayer for a taxable year, no annual additions[395] which are allocable to a taxable year may be made, by or on behalf of such individual, to any IRA to the extent such annual additions exceed the excess (if any) of the applicable dollar limit over the prior year aggregate applicable retirement plan balances. If any such annual additions are made to an IRA, an excise tax applies (see below).

For purposes of making that determination, the acquisition of an IRA (or the transfer to or contribution of amounts to an IRA) (1) by reason of the death of another individual, (2) on account of divorce or separation,[396] or (3) by a rollover contribution[397] is not treated as an annual addition. In addition, any employer or employee contributions by, or on behalf of, an individual to a SEP or a SIMPLE are not treated as annual additions for purposes of applying the limitation, but the excess (of the applicable dollar amount over the prior year aggregate applicable retirement plan balances) is reduced by the amount of such contributions in applying the limitation to other annual additions with respect to the individual.

Excise tax (special rules for IRAs with excess annual additions

The proposal imposes an excise tax on excess contributions, which for purposes of the proposal means, with respect to any taxable year, the sum of (A) the excess of the annual additions[398] to such IRAs over the limitation[399] for such taxable year, reduced by the amount of any other types of excess contributions,[400] and (B) the lesser of (1) the excess contributions determined under this proposal for the previous taxable year, with respect to such IRAs, reduced

[395] An annual addition is defined as any contribution to an individual retirement plan.

[396] Pursuant to section 408(d)(6).

[397] Under sections 402(c), 402A(c)(3)(A), 403(a)(4), 403(b)(8), 408(d)(3)(A), 408A(e)(1), or 457(e)(16).

[398] Within the meaning of section 409B(b)(1), as added by this proposal.

[399] Determined under section 409B(a), that is, the excess (if any) of the applicable dollar limit over the prior year aggregate applicable retirement plan balances.

[400] Determined under section 4973(b) and (f), relating to contributions that exceed the general contribution limits that apply to traditional and Roth IRAs.

by the aggregate distributions from such plans for the taxable year[401] or (2) the amount (if any) by which the prior year aggregate applicable retirement plan balances exceed the applicable dollar amount for the taxable year.

Regulations

The Secretary is to prescribe such regulations and guidance as are necessary or appropriate to carry out the purposes of this proposal, including regulations or guidance that provide for the application of this proposal and the application of the proposed rules relating to increased minimum required distributions (described below)[402] in the case of a plans with a valuation date other than the last day of a calendar year.

Reporting requirements

The proposal requires certain additional reporting related to IRAs with high account balances. If, as of the close of any plan year, one or more participants in an applicable retirement plan have a vested account balance of at least $2,500,000[403] for that plan year, the plan administrator must file a statement with the Secretary which includes: (1) the name and identifying number of each such participant (without regard to whether such participant has separated from employment) and (2) the amount to which each such participant is entitled. If a plan that is subject to this reporting requirement must file a Form 8955-SSA,[404] then the plan administrator must include the required information on the IRS Form 8955-SSA for that plan year rather than file a separate statement with the Secretary.

Increase in minimum required distributions for high-income taxpayers with large retirement account balances

Increased minimum required distributions are required to be made for a taxable year by applicable taxpayers[405] whose retirement account balances exceed the applicable dollar amount ($10,000,000, adjusted for inflation). For purposes of this proposal, all qualified retirement plans and eligible deferred compensation plans of the taxpayer which are treated as applicable retirement plans are taken into account in computing the excess that is subject to increased

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[401] Including increased minimum distributions required under section 4974(e) to the extent not contributed in a rollover contribution to another eligible retirement plan in accordance with section 402(c), 402A(c)(3)(A), 403(a)(4), 403(b)(8), 408(d)(3), 408A(d)(3), or 457(e)(16).

[402] Section 4974(e), as added by this proposal.

[403] The $2,500,000 vested account balance used to determine this reporting requirement is increased for cost-of-living adjustments for taxable years beginning in 2023 or later, with adjustments for the accumulation limit being rounded to the next lowest multiple of $250,000.

[404] IRS Form 8955-SSA is filed by plan administrators of plans subject to the vesting standards of section 203 of ERISA and is used to satisfy the reporting requirements of section 6057(a).

[405] Defined above.

minimum required distributions during a taxable year, and solely for that purpose, such plans are treated as one plan.

The increase in the minimum required distributions for a taxable year is equal to the excess (if any) of (a) the sum of (1) 100 percent of the "applicable Roth excess amount" plus (2) 50 percent of the "excess aggregate vested retirement plan balance" reduced by the applicable Roth excess amount ***over*** (b) the sum of the minimum required distributions (determined without regard to this proposal) for all such plans.

The excess aggregate vested retirement plan balance for a taxable year is equal to the amount by which the aggregate vested balances to the credit of the taxpayer (whether as a participant, owner, or beneficiary) in all applicable retirement plans (determined as of the close of the calendar year preceding the calendar year in which the taxable year begins) exceed the applicable dollar amount for the calendar year in which the taxable year begins and applies to a taxpayer without regard to whether amounts are otherwise required to be distributed as minimum required distributions.[406]

The applicable Roth excess amount applies to a taxpayer for a taxable year if the aggregate vested balances to the credit of the taxpayer (whether as a participant, owner or beneficiary) in all applicable retirement plans (determined as of the close of the calendar year preceding the calendar year to which the taxable year begins) exceeds 200 percent of the applicable dollar amount for the calendar year in which the taxable year begins (or $20,000,000, adjusted for inflation). The applicable Roth excess amount for any taxable year to which this proposal applies is an amount equal to the lesser of (1) the excess as determined in the prior sentence, or (2) the aggregate balances to the credit of the taxpayer (whether as a participant, owner or beneficiary) in all Roth IRAs and Roth designated accounts.[407]

Coordination and application of the rule

If this increase in minimum required distributions applies to a taxpayer for any taxable year, the general excise tax that applies to minimum required distributions that are not timely distributed is first applied to minimum required distributions determined without regard to this proposal (and nothing in this proposal is to be construed to affect the amount of any such minimum required distributions) and then to any increase in minimum required distributions required by this proposal.

With respect to any increased minimum required distributions, the portion of any increase in minimum required distributions equal to the applicable Roth excess amount is allocated first to Roth IRAs and then to designated Roth accounts.[408] Once that allocation is complete, the taxpayer may, in such form and manner as the Secretary may prescribe, allocate any increase in minimum required distributions to applicable retirement plans, treated as one plan for purposes

[406] Under sections 401(a)(9), 403(b)(10), 408((a)(6), 408(b)(3), or 457(d)(2).

[407] Within the meaning of section 402A.

[408] Within the meaning of section 402A.

of this proposal, in such manner as the taxpayer chooses subject to certain requirements. If the taxpayer has account balances in one or more employee stock ownership plans ("ESOPs"),[409] any portion of which is invested in employer securities which are not readily tradable on an established securities market, the increase in minimum required distributions shall be allocated: (1) first, to all account balances of the taxpayer in all applicable retirement plans (other than such portions that are invested in employer securities which are not readily tradable on an established securities market) in the manner described above, and then to such portions in such manner as the taxpayer chooses. The Secretary must prescribe regulations under which a taxpayer may elect for the first taxable year of the taxpayer beginning in 2022, in which any such increase is allocated to any such portion of an account balance in an ESOP, to have such portion distributed over a period of years not greater than the period specified by the Secretary in such regulations (and any distributions made in accordance with such election will be treated for purposes of this section as made in the first taxable year).

A defined contribution plan will not constitute a qualified plan unless it provides that an employee, who certifies to the plan that he or she is a taxpayer subject to increased minimum required distributions,[410] may elect to receive a distribution from an employee's defined contribution plan account[411] in such amount as the employee may elect, including any amounts attributable to a qualified cash or deferred arrangement.[412] Any distribution from an applicable retirement plan which is attributable to any increase in minimum required distributions by reason of this proposal is, similar to other minimum required distributions, not treated as an eligible rollover distribution.

Ten percent early distribution tax

Such distributions to satisfy the requirements of this proposal are excepted from the ten percent[413] tax on early distributions from qualified retirement plans to the extent such distributions for the taxable year do not exceed the amount required to be distributed from such plan.

[409] As defined in sec. 4975(e)(7).

[410] Under section 4974(e).

[411] Including from a custodial account under section 403(b)(7)(A), contributions made pursuant to a salary reduction agreement (within the meaning of section 402(g)(3)) from an annuity contract pursuant to section 403(b)(11), or from a governmental eligible deferred compensation plan under section 457.

[412] The proposal also amends section 401(a) by adding a new section 401(a)(39) providing for such a distribution. Similar rules are also added for section 403(b) arrangements and governmental eligible deferred compensation plans. Secs. 403(b)(7)(A) and 457(d)(1). However, this rule does not apply to an ESOP to the extent provided under regulations prescribed by the Secretary pursuant to section 4974(e)(4)(B)(iii).

[413] Sec. 72(t).

Withholding

A distribution from a qualified retirement plan, a section 403(b) arrangement, or from a governmental eligible deferred compensation plan to satisfy the requirements of this proposal[414] is treated as a nonperiodic distribution to which 35 percent withholding is required.[415] An individual may not elect to not have withholding apply to such distributions.[416] Withholding does not apply to a qualified distribution from a designated Roth account.[417]

Plan amendments

With respect to any plan or contract amendments required by this proposal to increase minimum required distributions or pursuant to any regulations issued by the Secretary, such plan or contract will be treated as being operated in accordance with the terms of the plan during the period beginning on the date the legislative or regulatory amendment takes effect (or in the case of a plan or contract amendment not required by such legislative or regulatory amendment, the effective date specified in such amendment), and ending on or before the last day of the first plan year beginning after December 31, 2022, or such later date as the Secretary may prescribe, if the plan or contract is operated as if such plan or contract amendment were in effect, and such plan or contract amendment applies retroactively for such period.

With respect to governmental plans or collectively bargained plan to which this provision applies, the end date for the period specified will be December 31, 2024 rather than December 31, 2022.

Effective Date

With respect to the proposal related to limiting contributions to certain IRAs of high-income taxpayers and the excise tax on excess annual additions, the proposal is applicable to taxable years beginning after December 31, 2021.

With respect to the reporting requirements, the proposal is applicable to plan years beginning after December 31, 2021.

With respect to the increased minimum required distributions, the proposal is generally applicable to taxable years beginning after December 31, 2021.

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[414] Pursuant to section 401(a)(39), the last sentence of section 403(b)(7)(A), the last sentence of section 403(b)(11), and the last sentence of section 457(d)(1).

[415] Sec. 3405(b).

[416] Sec. 3405(b)(2).

[417] Within the meaning of section 402A.

With respect to the special rules for plans related to the increased minimum required distributions, the proposal is applicable to plan years beginning after December 31, 2021.

With respect to plan amendments, the proposal is generally effective as of the date of enactment.

H. Other Provisions Relating to Individual Retirement Plans

1. Tax treatment of rollovers to Roth IRAs and accounts

Present Law

In general

Background on IRAs may be found in section G of this document.

Roth IRA conversions

There are two basic types of IRAs under present law: traditional IRAs and Roth IRAs. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, and distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) and, if certain requirements are satisfied, distributions are not includible in gross income. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of (1) a certain dollar amount ($6,000 for 2021) plus $1,000 for an individual who has attained age 50 or (2) the individual's compensation.

Taxpayers generally may convert any amount in a traditional IRA into an amount in a Roth IRA through a distribution from the traditional IRA and rollover to a Roth IRA (either a direct payment or a 60-day rollover).[418] The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that the 10 percent early distribution tax[419] does not apply. Distributions from employer-sponsored retirement plans that are not from designated Roth accounts (described below) may also be contributed to a Roth IRA as a rollover and thereby converted to a Roth IRA amount. The amount rolled over must be included in gross income to the extent required if not rolled over. However, for both types of conversions, the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

In-plan Roth conversions

Section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans

A qualified defined contribution plan may allow an employee to make elective deferrals (that is, contributions made pursuant to an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement).[420] A plan with this feature is generally referred to as a section 401(k) plan. A section 403(b) plan may also allow an employee

[418] A conversion can also be achieved by simply redesignating the traditional IRA as a Roth IRA if the entire balance in the account is converted.

[419] Section 72(t).

[420] Sec. 401(k).

to make elective deferrals. The elective deferrals generally are excludable from gross income (pretax elective deferrals) and only taxed along with attributable earnings upon distribution from the plan. Alternatively, the plan may include a qualified Roth contribution program under which eligible employees are offered a choice of either making pretax elective deferrals or making elective deferrals that are not excluded from income and are designated as Roth contributions.[421] If certain requirements are satisfied, distributions of designated Roth contributions and attributable earnings are excluded from gross income. The employer may also make nonelective and matching contributions for employees under a section 401(k) or 403(b) plan. These are not permitted to be designated as Roth contributions and generally are pretax contributions. A plan may also allow participants to make elective after-tax contributions that are not elective deferrals and are not treated as designated Roth contributions.

A limit applies to the aggregate amount of elective deferrals (both pretax elective deferrals and designated Roth contributions) that an employee is permitted to contribute to section 401(k) and section 403(b) plans for a taxable year. The limit is $19,500 for 2021, plus an additional catch-up amount of $6,500 for 2021 if the employee is age 50 or older (or the employee's compensation if less than this sum). Total contributions, including pretax employer nonelective and matching contributions, elective deferrals (but not including catch-up contributions), and after-tax contributions, to a section 401(k) plan or 403(b) plan for a plan year for an employee generally cannot exceed $58,000 for 2021 (or the employee's compensation, if less).[422]

A governmental section 457(b) plan may also provide for elective deferrals. Contributions to a governmental section 457(b) plan are subject to a limit of $19,500 for 2021 plus an additional $6,500 catch-up contribution amount for 2021 for employees at least age 50 (or the employee's compensation, if less).[423] This limit is separate from the limit on elective deferrals to section 401(k) and section 403(b) plans.[424] As in the case of a section 401(k) plan or a section 403(b) plan, the plan may include a qualified Roth contribution program under which employees are given the choice between making pretax elective deferrals and designated Roth contributions.

<u>Designated Roth accounts</u>

All designated Roth contributions made under a qualified Roth contribution program must be maintained in a separate account (a designated Roth account) under the plan. A

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[421] Sec. 402A. Under Treas. Reg. secs. 1.401(k)-1(f) and 1.403(b)-3(c), a plan is not permitted to only allow employees to make designated Roth contributions; pretax elective deferrals must also be permitted.

[422] Secs. 415(c) and 403(b)(1).

[423] Under a special rule, additional catch-up contributions may be made by a participant to a governmental section 457(b) for the last three years before attainment of normal retirement age.

[424] For example, if an employee participates in both a section 403(b) plan and a governmental section 457(b) plan of the same employer, the employee may contribute up to $19,500 (plus $6,500 catch-up contributions if at least age 50) to the section 403(b) plan and up to $19,500 (plus $6,500 catch-up contributions if at least age 50) to the section 457(b) plan.

qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after (1) an employee's completion of a specified five-year period and (2) the employee's attainment of age 59½, death, or disability.

A distribution from a designated Roth account (other than a qualified distribution) is included in the distributee's gross income to the extent allocable to pretax earnings on the account and excluded from gross income to the extent allocable to the after-tax designated Roth contributions (commonly referred to as "basis" in the account).

Roth conversions

A section 401(k) plan, section 403(b) plan, or governmental section 457(b) plan that maintains a qualified Roth contribution program may allow amounts held in accounts that are not designated Roth accounts ("non-Roth accounts") to be transferred ("converted"). The transfer is allowed whether or not the amount is otherwise distributable. However, the converted amount must be included in gross income as though distributed, as in the case of Roth IRA conversions, and the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

Description of Proposal

Under the proposal, in the case of an applicable taxpayer, amounts held in traditional IRAs may not be converted to amounts held in Roth IRAs. Further, amounts held in non-Roth accounts in section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans by an applicable taxpayer may not be converted into either amounts held in a designated Roth account or a Roth IRA. Amounts distributed from a Roth IRA or from a designated Roth account may be rolled over to a Roth IRA.

An applicable taxpayer is a taxpayer whose adjusted taxable income for a taxable year[425] exceeds (1) $450,000 in the case of a taxpayer who is a married individual filing a joint return or a surviving spouse;[426] (2) $425,000 in the case of a taxpayer who is a head of household;[427] and (3) $400,000 for a taxpayer not described in (1) or (2).

In addition, for all taxpayers (regardless of income level), the proposal prohibits amounts held in non-Roth accounts in an employer-sponsored retirement plan[428] or in a traditional IRA

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[425] Adjusted taxable income is defined in section 409(B)(b)(4)(C) (which section is added to the Code by section 138301 of this Subtitle I) and means taxable income determined without regard to (a) any deduction for annual additions to individual retirement plans to which section 409B(a) applies and (b) any increase in minimum required distributions by reason of section 4974(e) (which section is added to the Code by section 138302 of this Subtitle I).

[426] As defined in section 2(a).

[427] As defined in section 2(b).

[428] A section 401(k) plan, section 403(b) plan, or a governmental section 457(b) plan.

from being converted to a Roth IRA or a designated Roth account if any portion of the distribution that is being converted consists of after-tax contributions.

Effective Date

With respect to the proposal prohibiting certain conversions to Roth IRAs or Roth designated accounts by applicable taxpayers, the proposal applies to distributions, transfers, and contributions made in taxable years beginning after December 31, 2031.

With respect to the proposal prohibiting conversions of employee after-tax contributions- in qualified retirement plans and IRAs to Roth IRAs or Roth designated accounts by all taxpayers, the proposal is effective for distributions, transfers, and contributions made after December 31, 2021.

2. Prohibition of IRA investments conditioned on account holder's status

Present Law

In general

Background on IRAs may be found in section G of this document.

Prohibited transactions

ERISA and the Code prohibit certain transactions ("prohibited transactions") between an employer-sponsored retirement plan and a disqualified person (referred to as a "party in interest" under ERISA).[429] Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules apply to qualified retirement plans and qualified retirement annuities,[430] as well as individual retirement accounts and annuities,[431] health savings accounts ("HSAs"),[432] Archer MSAs,[433] and Coverdell education savings accounts.[434]

Disqualified persons include: (1) a fiduciary of the plan; (2) a person providing services to the plan; (3) an employer with employees covered by the plan; (4) an employee organization

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[429] ERISA sec. 406; Code sec. 4975.

[430] Sections 401(a) and 403(a) provide the requirements for qualified retirement plans. The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans. However, under section 503, the trust holding assets of a governmental or church plan may lose its tax exempt status in the case of a prohibited transaction listed in section 503(b).

[431] These are included in the definition of "plan" under section 4975(e)(1).

[432] Sec. 223.

[433] Sec. 220.

[434] Sec. 530.

any of whose members are covered by the plan; (5) a direct or indirect owner of an interest of 50 percent or more in the employer or employee organization; or (6) a corporation, partnership, or trust or estate of which (or in which) an interest of 50 percent or more is held directly or indirectly by a person described in (1), (2), (3), (4) or (5). For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Prohibited transactions include the following transactions, whether direct or indirect, between a plan and a disqualified person: (1) the sale, exchange or leasing of property; (2) the lending of money or other extension of credit; (3) the furnishing of goods, services or facilities; (4) the transfer to, or use by or for the benefit of, a disqualified person, the income or assets of the plan; (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account; and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.[435] However, certain transactions are exempt from prohibited transaction treatment, for example, certain loans to plan participants.

Loss of exemption of IRA

An individual retirement account ("IRA") is exempt from taxation unless such account has ceased to be an IRA by reason of engaging in certain prohibited transactions.[436]

If during any taxable year of the individual for whose benefit any IRA is established, that individual or beneficiary of such individual engages in any prohibited transaction with respect to that IRA, the IRA will cease to be an IRA as of the first day of such taxable year.[437] In that case, the IRA is treated as having distributed an amount equal to the fair market value of all the assets in the account, as of the first day of the taxable year in which the prohibited transaction occurs.

If the fair market value of the IRA assets exceeds the basis in the account, the individual has taxable gain that is includible in gross income. If the individual is under age 59½, the

[435] Sec. 4975(c)(1). Under section 4975(d), certain transactions are statutorily exempt from prohibited transaction treatment. In addition, under section 4975(c)(2), an administrative exemption may be granted, on either an individual or class basis, subject to a finding that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan.

[436] Sec. 408(e)(1). Section 408(e)(1) and this proposal apply to individual retirement accounts as defined in section 408(a), not to individual retirement annuities under section 408(b). Similarly, under section 408(m), an individual retirement account, or an individually-directed account under a section 401(a) qualified plan, is prohibited from being invested in collectibles. A collectible generally means a work of art, a rug or antique, a metal or gem, a stamp or coin, an alcoholic beverage, or certain other tangible personal property. The acquisition of a collectible by an IRA is also treated as a distribution from the IRA in an amount equal to the cost of the collectible.

[437] Sec. 408(e)(2) and 4975(c)(3). This treatment also applies to an interest in a trust created as an individual retirement account under section 408(c).

individual may also be subject to the 10-percent tax on early distributions.[438] The individual and the individual's beneficiaries are exempt, however, from the excise tax that otherwise applies to prohibited transactions.[439]

Description of Proposal

The proposal provides that no part of the trust funds of an IRA may be invested in any security if the issuer of that security (or any other person specified by the Secretary) requires the individual on whose behalf the trust is maintained to make a representation to the issuer, or such other person, that such individual: (1) has a specified minimum amount of income or assets; (2) has completed a specified minimum level of education, or (3) holds a specific license or credential.

If, during any taxable year of the individual for whose benefit any IRA is maintained, the investment of any part of the funds of such IRA does not comply with such restriction, the IRA ceases to be an IRA as of the first day of that taxable year. Thus, as in the case of an IRA owner who engages in a prohibited transaction, the IRA is treated as having distributed an amount equal to the fair market value of all the assets in the account as of the first day of the taxable year.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021. However, in the case of any such investment held in the individual's IRA as of the date of enactment of this proposal, the proposal is effective, with respect to such assets, for taxable years beginning after December 31, 2023.

3. Statute of limitations with respect to IRA noncompliance

Present Law

In general

Background on IRAs may be found in section G of this document.

Excise taxes

ERISA and the Code prohibit certain transactions ("prohibited transactions") between an employer-sponsored retirement plan and a disqualified person (referred to as a "party in interest" under ERISA).[440] Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules

[438] Sec. 72(t).

[439] Sec. 4975(c)(3).

[440] ERISA sec. 406; Code sec. 4975.

apply to qualified retirement plans and qualified retirement annuities,[441] as well as individual retirement accounts and annuities ("IRAs"),[442] health savings accounts ("HSAs"),[443] Archer MSAs,[444] and Coverdell education savings accounts.[445]

Disqualified persons include: (1) a fiduciary of the plan; (2) a person providing services to the plan; (3) an employer with employees covered by the plan; (4) an employee organization any of whose members are covered by the plan; (5) a direct or indirect owner of an interest of 50 percent or more in the employer or employee organization; or (6) a corporation, partnership, or trust or estate of which (or in which) an interest of 50 percent or more is held directly or indirectly by a person described in (1), (2), (3), (4) or (5). For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Prohibited transactions include the following transactions, whether direct or indirect, between a plan and a disqualified person: (1) the sale, exchange or leasing of property; (2) the lending of money or other extension of credit; (3) the furnishing of goods, services or facilities; (4) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan; (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account; and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.[446] However, certain transactions are exempt from prohibited transaction treatment, for example, certain loans to plan participants.

Under the Code, if a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited

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[441] Sections 401(a) and 403(a) provide the requirements for qualified retirement plans. The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans. However, under section 503, the trust holding assets of a governmental or church plan may lose its tax exempt status in the case of a prohibited transaction listed in section 503(b).

[442] These are included in the definition of "plan" under section 4975(e)(1).

[443] Sec. 223.

[444] Sec. 220.

[445] Sec. 530.

[446] Sec. 4975(c)(1). Under section 4975(d), certain transactions are statutorily exempt from prohibited transaction treatment. In addition, under section 4975(c)(2), an administrative exemption may be granted, on either an individual or class basis, subject to a finding that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan.

transaction is not corrected within a certain period and is 100 percent of the amount involved.[447] Under ERISA, the Secretary of Labor may assess a civil penalty against a person who engages in a prohibited transaction, other than a transaction with a plan covered by the prohibited transaction rules of the Code (*i.e.*, involving a qualified retirement plan or annuity). The penalty may not exceed five percent of the amount involved in the transaction. If the prohibited transaction is not corrected within 90 days after notice from the Secretary of Labor, the penalty may be up to 100 percent of the amount involved in the transaction.[448] For purposes of these rules, the "amount involved" generally means the greater of (1) the amount of money and the fair market value of the other property given, or (2) the amount of money and the fair market value of other property received by the plan.[449]

<u>Loss of exemption of IRA</u>

An IRA is exempt from taxation unless such account has ceased to be an IRA by reason of engaging in certain prohibited transactions.[450]

If during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or beneficiary of such individual engages in any prohibited transaction with respect to that IRA, the IRA will cease to be an individual retirement account as of the first day of such taxable year.[451] In that case, the individual retirement account is treated as having distributed an amount equal to the fair market value of all the assets in the account, as of the first day of the taxable year in which the prohibited transaction occurs.

If the fair market value of the IRA assets exceeds the basis in the account, the individual has taxable gain that is includible in gross income. If the individual is under age 59½, the individual may also be subject to the 10-percent tax on early distributions.[452] The individual and

[447] The terms "correction" and "correct" mean, with respect to a prohibited transaction, undoing the transaction to the extent possible, but in any case, placing the plan in a financial position not worse than the position in which it would be if the disqualified person were acting under the highest fiduciary standards.

[448] A prohibited transaction violates the fiduciary responsibility provisions of ERISA. Under section 502(l) of ERISA, in the case of a violation of fiduciary responsibility, a civil penalty is generally imposed of 20 percent of the amount recovered from a person with respect to the violation in a settlement agreement with the Department of Labor or a judicial proceeding, but the penalty is reduced by the amount of any excise tax or other civil penalty with respect to a prohibited transaction.

[449] Amount involved is defined in Code section 4975(f)(4), which is cross-referenced in ERISA section 502(i).

[450] Sec. 408(e)(1).

[451] Sec. 408(e)(2) and 4975(c)(3). This treatment also applies to an interest in a trust created as an individual retirement account under section 408(c).

[452] Sec. 72(t).

the individual's beneficiaries are exempt, however, from the excise tax that otherwise applies to prohibited transactions.[453]

Statute of limitations

In general, in order for the IRS to assess a tax, the tax must be assessed within three years after the return to which the tax relates was filed (referred to as the "statute of limitations on assessment"), regardless of whether the return is filed by the due date for the return.[454] For this purpose, a return filed before the due date for the return is treated as filed on the due date.[455]

In some cases, a longer statute of limitation applies. For example, the statute of limitations is six years after an income tax return is filed if the taxpayer omits an amount of includible income exceeding 25 percent of the income shown on the return.[456] If certain information required to be included with a return is not so included, the statute of limitations may be determined by reference to the date when the information is provided to the IRS, rather than when the return was filed.[457] In addition, in some cases in which a tax results from a particular transaction, the statute of limitations may be determined by reference to the date when the IRS is notified of the transaction, rather than when the return was filed.[458]

Description of Proposal

The proposal extends the statute of limitations in certain cases relating to IRAs and prohibited transactions. In the case of any substantial error (willful or otherwise) in the reporting on a return of any information relating to the valuation of investment assets of an IRA, the time for assessment of any tax, or increase in tax, imposed with respect to such an IRA will not expire before the date that is six years after the return containing such error is filed (whether or not such return was filed on or after the date prescribed).

With respect to a prohibited transaction, whether or not it involves an IRA, the time for assessment of any tax[459] will not expire before the date which is six years after the return was filed (whether or not such return was filed on or after the date prescribed.

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[453] Sec. 4975(c)(3).

[454] Sec. 6501(a). Under section 6501(c)(3), in the case of a failure to file a return, tax may be assessed at any time.

[455] Sec. 6501(b)(1).

[456] Sec. 6501(e)(1).

[457] See, for example, sec. 6501(c)(10), relating to listed transactions.

[458] See, for example, 4979(e)(2)(D), relating to certain prohibited allocations of employer securities under an employee stock ownership plan.

[459] Imposed by section 4975.

Effective Date

The proposal applies to taxes with respect to which the three-year statute of limitations period ends (without regard to the amendment made by this proposal) after December 31, 2021.

4. Prohibition of investment of IRA assets in entities in which the owner has a substantial interest

Present Law

Background on IRAs may be found in section G of this document, and background on prohibited transactions may be found in section H.2 of this document.

Description of Proposal

The proposal prohibits any individual retirement account ("IRA")[460] funds from being invested in a non-publicly-traded entity if the IRA owner has an interest of 10 percent or more. Specifically, no IRA funds may be invested in a corporation, partnership or other unincorporated enterprise, or trust or estate, the interests of which are not readily tradable on an established market, if 10 percent or more of the entity is owned (directly or indirectly) or held by the IRA owner. For this purpose, an interest is measured by reference to (1) in the case of a corporation, the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of the corporation, (2) in the case of a partnership or other enterprise, the capital interest or profits interest in the partnership or enterprise, and (3) in the case of a trust or estate, the beneficial interest in the trust or estate.

In determining ownership for purposes of the proposal, constructive ownership rules apply.[461] For example, an individual is treated as owning interests held by certain family members, defined for this purpose as the individual's spouse, ancestors, lineal descendants, and spouses of lineal descendants. In addition, any interest held by the IRA is treated as held by the IRA owner. Thus, an interest held by the IRA and an interest held by the IRA owner, as well as any constructively owned interest, are combined for purposes of the proposal.

The proposal also prohibits an IRA from investing in a corporation, partnership, or other unincorporated enterprise if the IRA owner is an officer or director (or individual having powers or responsibilities similar to officers or directors) of such entity.

If, during any taxable year of an IRA owner, the assets of the IRA are invested in a non-publicly-traded entity in which the IRA owner has an interest of 10 percent or more, or in which the IRS owner is an officer or director, the IRA ceases to be an IRA as of the first day of the taxable year. In that case, an amount is included in income, determined as if there were a

[460] Sec. 408(a). This proposal does not apply to individual retirement annuities, described in section 408(b).

[461] The proposal incorporates the constructive ownership rules under section 4975(e)(4) and (5), which refer to the rules of section 267(c), but using the definition of family members under section 4975(e)(6).

distribution on the first day of the taxable year in an amount equal to the fair market value (as of that day) of all the assets in the account as of that day.

Effective Date

The proposal applies to investments made in taxable years beginning after December 31, 2021. However, a special rule applies in the case of existing investments. If an IRA holds an investment prohibited under this proposal on the date of enactment of the proposal, the proposal applies to such investment for taxable years beginning after December 31, 2023.

5. IRA owners treated as disqualified persons for purposes of prohibited transactions rules

Present Law

Background on IRAs may be found in section G of this document, and background on prohibited transactions may be found in section H.2 of this document.

Description of Proposal

The proposal modifies the statutory definition of disqualified person for purposes of the prohibited transaction rules to specifically provide that an IRA owner is a disqualified person with respect to the IRA (regardless of whether the IRA owner would be a disqualified person on another basis). In addition, the following are treated as disqualified persons: (1) a family member of the IRA owner; (2) a corporation, partnership, or trust or estate in which an interest of 50 percent or more is held directly or indirectly by the IRA owner; and (3) a 10-percent or more (in capital or profits) partner or joint venturer of the IRA owner. The constructive ownership rules applicable under present law apply for purposes of the proposal. Moreover, for purposes of (2) and (3) above, any interest held by the IRA is treated as held by the IRA owner. Thus, an interest held by the IRA and an interest held by the IRA owner, as well as any constructively owned interest, are combined for those purposes.[462]

Effective Date

The proposal applies to transactions occurring after December 31, 2021.

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[462] The proposal also revises section 408(e)(2) to clarify that it applies to the individual for whose benefit an IRA is maintained, that is, the IRA owner as used herein.

I. Funding the Internal Revenue Service and Improving Taxpayer Compliance

1. Funding of the Internal Revenue Service

Present Law

Almost all the IRS operating costs are funded by congressional appropriations.[463] For fiscal year 2021, the IRS received appropriations of $11.919 billion distributed among four accounts: $2.556 billion for taxpayer services, $5.213 billion for enforcement, $3.928 billion for operations support, and $223 million for business systems modernization.[464]

Description of Proposal

The proposal provides for the following appropriation amounts for fiscal year 2022 (in addition to amounts otherwise available) through September 30, 2031: (i) $78.935 billion for strengthening tax enforcement and increasing voluntary compliance, expanding audits and other enforcement activities, and modernizing information technology to support enforcement; (ii) $410 million for the Treasury Inspector General for Tax Administration to provide oversight of the IRS, including ensuring taxpayer privacy and that no undue burden is imposed on small businesses from IRS enforcement; and (iii) $157 million for the United States Tax Court for adjudicating tax disputes.

The proposal specifies that the use of the additional resources for tax enforcement is not intended to increase taxes on any taxpayer with taxable income below $400,000.

Effective Date

The proposal is effective as of the date of enactment.

2. Application of backup withholding with respect to third party network transactions

Present law requires persons to file an information return concerning certain transactions with other persons.[465] The person filing an information return generally is also required to provide the other party in the transaction with a written statement showing certain information and the contact information for the filer.[466] These returns are intended to assist taxpayers in

[463] Information is available at https://www.irs.gov/pub/irs-pdf/p4450.pdf (last visited September 13, 2021).

[464] Consolidated Appropriations Act, Pub. L. No. 116-260, Div. E, Title I, December 27, 2020. The IRS also received appropriations to carry out rebates and address COVID-related tax administration issues of $178 million for taxpayer services, $273 million for operations support, and $57 million for enforcement. Pub. L. No. 116-260, Div. N, Title II, Subtitle B, sec. 272 (the "COVID-related Tax Relief Act of 2020"), December 27, 2020. In addition, the IRS received $1.465 billion for the administration of the advance payments, the provision of taxpayer assistance, and the furtherance of integrated, modernized, and secure IRS systems, and $397 million to carry out advance payments of the child tax credit. American Rescue Plan Act of 2021, Pub. L. No. 117-2, Title IX, Subtitle G, secs. 9601 and 9611, March 11, 2021.

[465] Secs. 6041 through 6050Y.

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

preparing their income tax returns and to help the IRS determine whether such income tax returns are correct and complete.

Returns relating to payments made in settlement of payment card and third party network transactions

Starting in 2012 (for payments received in 2011), payment settlement entities are required to report the gross amount of payments made in settlement of payment card transactions and third party network transactions to the IRS and to businesses that receive these payments.[467]

Payment settlement entities are required to report the following on Form 1099-K: (1) all payments made in settlement of payment card transactions, such as credit cards and (2) payments in settlement of third party network transactions if the *de minimis* exception, described below, does not apply. Specifically, any payment settlement entity making a payment to a participating payee in settlement of reportable payment transactions must report annually to the IRS and to the participating payee the gross amount of such reportable payment transactions, as well as the name, address, and TIN of the participating payees. A "reportable payment transaction" means any payment card transaction and any third party network transaction.

A "payment settlement entity" means, in the case of a payment card transaction, a merchant acquiring entity and, in the case of a third party network transaction, a third party settlement organization.[468] A "participating payee" means, in the case of a payment card transaction, any person who accepts a payment card as payment and, in the case of a third party network transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction.[469] A "person" includes a governmental unit, although, generally, not someone with a foreign address.

Returns relating to payments made in settlement of payment card transactions

For purposes of the reporting requirement, the term "merchant acquiring entity" means a bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions.[470] A "payment card transaction" means any transaction in which a payment card is accepted as payment.[471] A "payment card" is defined as any card (*e.g.*, a credit card or debit card) which is issued pursuant to an agreement or arrangement which provides for: (1) one or more issuers of such cards; (2) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (3)

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[467] Sec. 6050W; Pub. L. No. 110-289 (2008), sec. 3091(a) added sec. 6050W, effective generally for returns for calendar years beginning after December 31, 2010.

[468] Sec. 6050W(b).

[469] Sec. 6050W(d)(1).

[470] Sec. 6050W(b)(2).

[471] For this purpose, the acceptance as payment of any account number or other indicia associated with a payment card also qualifies a payment card transaction.

standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept such cards as payment.[472] Thus, under the provision, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the IRS the business's gross credit card transactions for each calendar year on a Form 1099-K, *Payment Card and Third Party Network Transactions*. The bank also is required to provide a copy of the information return to the business.

Returns relating to payments made in settlement of third party network transactions

The statute also requires reporting on a third party network transaction. The term "third party network transaction" means any transaction which is settled through a third party payment network.[473] A "third party payment network" is defined as any agreement or arrangement: (1) that involves the establishment of accounts with a central organization by a substantial number of persons (*e.g.*, more than 50) who are unrelated to such organization, provide goods or services, and have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement; (2) that provides for standards and mechanisms for settling such transactions; and (3) that guarantees persons providing goods or services pursuant to such agreement or arrangement that such persons will be paid for providing such goods or services.[474]

In the case of a third party network transaction, the payment settlement entity is the third party settlement organization, which is defined as the central organization which has the contractual obligation to make payment to participating payees of third party network transactions.[475] Thus, an organization generally is required to report if it provides a network enabling buyers to transfer funds to sellers who have established accounts with the organization and have a contractual obligation to accept payment through the network. However, an organization operating a network which merely processes electronic payments (such as wire transfers, electronic checks, and direct deposit payments) between buyers and sellers, but does not have contractual agreements with sellers to use such network, is not required to report. Similarly, an agreement to transfer funds between two demand deposit accounts will not, by itself, constitute a third party network transaction.

A third party payment network does not include any agreement or arrangement that provides for the issuance of payment cards as defined by the provision. In addition, there is an exception for *de minimis* payments that applies to payments made by third party settlement organizations but not to payments made by merchant acquiring entities. For calendar years beginning prior to January 1, 2022, a third party settlement organization is not required to report unless the aggregate value of third party network transactions with respect to a participating payee for the year exceeds $20,000 and the aggregate number of such transactions with respect

[472] Sec. 6050W(d)(2).

[473] Sec. 6050W(c)(3).

[474] Sec. 6050W(d)(3).

[475] Sec. 6050W(b)(3).

to a participating payee exceeds 200.[476] If a payment of funds is made to a third party settlement organization by means of a payment card (*i.e.*, as part of a payment card transaction), the $20,000 and 200 transaction *de minimis* rule continues to apply to any reporting obligation with respect to payment of such funds to a participating payee by the third party settlement organization made as part of a third party network transaction.

For example, in calendar year 2021, if a business that provides a web-based rental platform for short-term travelers is considered a third party settlement organization, it does not have to provide a Form 1099-K to property owners participating on its web-based platform who have received payments of $20,000 or less. On the other hand, if that company is considered a merchant acquiring entity, it would have to issue a Form 1099-K to all payees participating on its platform who have received payments of any amount starting with the first dollar.

For calendar years beginning after December 31, 2021, the threshold below which a third party settlement organization is not required to report payments to participants in its network was recently lowered and modified. Beginning in such calendar years, a third party settlement organization is required to report third party network transactions with any participating payee that exceed a minimum threshold of $600 in aggregate payments.[477] There is no longer a threshold requirement for the number of transactions. In addition, effective on the date of enactment, Congress clarified that third party network transactions only include transactions for the provision of goods or services. Reporting is not required for other transactions, including personal gifts, charitable contributions, and reimbursements.

Rules regarding reporting requirements

There are also reporting requirements on intermediaries who receive payments from a payment settlement entity and distribute such payments to one or more participating payees.[478] Such intermediaries are treated as participating payees with respect to the payment settlement entity and as payment settlement entities with respect to the participating payees to whom the intermediary distributes payments. Thus, for example, in the case of a corporation that receives payment from a bank for credit card sales effectuated at the corporation's independently-owned franchise stores, the bank is required to report the gross amount of reportable payment transactions settled through the corporation (notwithstanding the fact that the corporation does not accept payment cards and would not otherwise be treated as a participating payee). In turn, the corporation, as an intermediary, would be required to report the gross amount of reportable payment transactions allocable to each franchise store. The bank would have no reporting obligation with respect to payments made by the corporation to its franchise stores.

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[476] Sec. 6050W(e).

[477] Sec. 6050W(e); Pub. L. No. 117-2, Title IX, sec. 9674, March 11, 2021, amending sec. 6050W(e), effective generally for returns for calendar years beginning after December 31, 2021.

[478] Sec. 6050W(b)(4).

If a payment settlement entity contracts with a third-party facilitator to settle reportable payment transactions on behalf of the payment settlement entity, the third party facilitator is required to file the annual information return in lieu of the payment settlement entity.[479]

Under the statute, returns shall be made at such time and in such form and manner as the Secretary may require by regulations.[480] Pursuant to regulations, the reporting is annual, and, in the information return for each calendar year, payment settlement entities must provide the aggregate reportable payment transactions for the calendar year and the aggregate reportable payment transactions for each month of the calendar year.[481] The payment settlement entity is required to file the information return with the IRS on or before February 28th (March 31st if filing electronically) of the year following the calendar year for which the return must be filed.[482] Statements are required to be furnished to the participating payees on or before January 31st of the year following the calendar year for which the return was required to be made.[483]

The Secretary has exercised authority under these rules to issue guidance to implement the reporting requirement, including rules to prevent the reporting of the same transaction more than once.[484] The reportable payment transactions subject to information reporting generally are subject to backup withholding requirements.

<u>Backup withholding</u>

Under section 3406, a payor is required to deduct and withhold income tax on certain "reportable payments" at a rate equal to 24 percent[485] 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.[486] The requirement to deduct and withhold in the case of a notified payee underreporting or a payee certification failure apply solely to reportable interest or dividend payments. The deducting and withholding requirements under section 3406 are referred to as backup withholding.

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[479] Sec. 6050W(b)(4)(B); Treas. Reg. sec. 1.6050W-1(d)(2)

[480] Sec. 6050W(a).

[481] Treas. Reg. sec. 6050W-1(a).

[482] Treas. Reg. sec. 1.6050W-1(g). Taxpayers that file these information returns that report reportable payment transactions are entitled to a 30-day automatic extension of time to file. Treas. Reg. sec. 1.6081-8(a) (effective for requests for extension of time to file certain information returns due after December 31, 2016).

[483] Sec. 6050W(f); Treas. Reg. sec. 1.6050W-1(h).

[484] Treas. Reg. sec. 1.6050W-1(a)(4)(ii).

[485] The backup withholding rate is the fourth lowest rate of tax applicable under section 1(c). In 2021, this rate is 24 percent.

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

Reportable payments are defined as any reportable interest or dividend payment and any other reportable payment.[487] 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 section (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 section (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, (ii) 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, broker payments, and other payments.

In general, a payment is a 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.[488] Therefore, payments made in settlement of payment card and third party settlement transactions required to be reported under section 6050W are subject to backup withholding without regard to the minimum dollar threshold applicable for the information reporting obligation of third party settlement organizations ($20,000 prior to 2022, $600 thereafter).[489]

In 2011, the Treasury Department and IRS determined that for third party settlement organizations the transactional threshold (200 transactions) for determining information reporting obligations under section 6050W should be met before a backup withholding obligation under section 3406 arises.[490] Following the amendments to the *de minimis* threshold for third party settlement organizations for calendar years beginning after December 31, 2021, there is no longer a transactional threshold for determining information reporting obligations under 6050W.

For payments required to be shown on a return under sections 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.[491] Such payments shall be treated as reportable payments, and therefore subject to backup withholding, only if (i) the aggregate amount of such payment and all previous payments

[487] Sec. 3406(b).

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

[489] See Treas. Reg. sec. 31.3406(b)(3)-5(b).

[490] Notice 2011-42, 2011-23 I.R.B. 866.

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

described in sections 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 sections 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 entities.[492] 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 taxpayer identification number.[493]

Description of Proposal

Under the proposal, a third party settlement organization generally shall not be subject to backup withholding on the first dollar of payments made in settlement of third party network transactions. Such transactions shall be treated as reportable payments, and therefore subject to backup withholding during any calendar year, only if (i) the aggregate amount of such payment and all previous payments made by the third party settlement organization to the participating payee during the calendar year equals or exceeds $600, or (ii) the third party settlement organization was required under section 6050W to file an information return for the preceding calendar year with respect to payments to the participating payee.

For payments made during calendar year 2022, the proposal provides that a third party network transaction required to be shown on a return required under section 6050W shall be treated as a reportable payment only if the aggregate number of transactions between a third party settlement organization and participating payee exceeds 200 within a calendar year. This one-year transition rule provides that a payment may be subject to backup withholding only if the transactional threshold is met, consistent with Notice 2011-42.

In addition, the proposal aligns the $600 dollar threshold for information reporting under section 6050W with the $600 dollar threshold for backup withholding under section 3406. Under the proposal, both thresholds are for transactions that equal or exceed $600.

Effective Date

The proposal is effective for calendar years beginning after December 31, 2021.

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

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

3. Limitation on deduction for qualified conservation contributions made by pass-through entities

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[494]

Qualified conservation contributions

Except where allowed by the Code, a taxpayer may not take a charitable deduction for a contribution of a partial interest in property (the "partial interest rule"). A qualified conservation contribution is one type of partial interest contribution for which a charitable deduction is allowed.[495]

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.[496] A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[497] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.[498] Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.[499]

Preferential rules apply in determining the amount of a taxpayer's deduction for a qualified conservation contribution. These rules generally allow an individual taxpayer making a

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[494] Secs. 170, 2055, and 2522, respectively.

[495] Sec. 170(f)(3)(B)(iii) and 170(h).

[496] Sec. 170(h)(1).

[497] Sec. 170(h)(2).

[498] See sec. 170(h)(3).

[499] Sec. 170(h)(4).

qualified conservation contribution to offset a higher percentage of her contribution base,[500] and a corporate taxpayer making such a contribution to offset a higher percentage of its taxable income, than taxpayers making charitable contributions of other types of property.[501]

IRS Notice 2017-10

On December 23, 2016, the IRS issued Notice 2017-10, which designates certain conservation easement transactions as listed transactions that are subject to certain disclosure and list maintenance requirements.[502] According to the Notice, "[t]he Department of the Treasury . . . and the Internal Revenue Service . . . are aware that some promoters are syndicating conservation easement transactions that purport to give investors the opportunity to obtain charitable contribution deductions in amounts that significantly exceed the amount invested." The Notice generally provides that a transaction is a listed transaction under the Notice if an investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The investor purchases an interest in the pass-through entity that holds real property. The entity then contributes a conservation easement encumbering the property to a tax-exempt organization and allocates a charitable contribution deduction to the investor.

Accuracy-related penalty (sec. 6662)

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, (5) any substantial estate or gift tax valuation understatement, (6) any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, (7) any undisclosed foreign financial asset understatement, (8) any inconsistent estate basis, or (9) any overstatement of the deduction provided in section 170(p). If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[503] The section 6662

[500] An individual taxpayer's contribution base is her adjusted gross income computed without regard to any net operating loss carrybacks to the taxable year under section 162. Secs. 170(b)(1)(H).

[501] Sec. 170(b)(1)(E), (b)(2)(B), and (b)(2)(C).

[502] Treas. Reg. secs. 1.6011-4 and 301.6111-3. See also sec. 6501(c)(10) (special limitations period for assessment of tax related to a listed transaction that was not properly disclosed).

[503] Sec. 6662(d).

penalty generally is abated (even with respect to tax shelters[504]) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith and adequate disclosure is made.[505] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on [a professional] tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[506] However, if the underpayment is attributable to a reportable transaction, the standard for reasonable cause is more stringent,[507] and applies only if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Secretary may prescribe a list of positions that the Secretary believes do not meet the requirements for substantial authority under this provision.

With certain exceptions, section 6662 does not apply to any portion of an underpayment that is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A.[508]

The 20-percent penalty is increased to 40 percent when there is a gross valuation misstatement involving a substantial valuation overstatement, a substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatement, or when a transaction lacking economic substance or a foreign financial asset is not properly disclosed.[509] In the case of an overstatement of qualified charitable contributions, the 20-percent penalty is increased to 50 percent.[510]

Mandatory supervisory approval to assert penalty

Assessment of an addition to tax or penalty under the Code is barred in the absence of prior supervisory approval. Such approval requires that the initial determination of the penalty or addition to tax be approved in writing by the immediate supervisor of the person asserting the penalty. The Code authorizes the Secretary to designate a higher-level official to provide the supervisory approval. Certain penalties are exempt from the requirement for supervisory

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[504] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[505] Secs. 6662(d)(2)(B) and 6664(c).

[506] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B). See also Treas. Reg. sec. 1.6664-4(c).

[507] Secs. 6664(d).

[508] Sec. 6662(b) (flush language).

[509] Secs. 6662(h), (i), and (j).

[510] Sec. 6662(l).

approval, including those penalties "automatically calculated through electronic means."[511] Because the IRS bears the burden of producing evidence to support assessment of a penalty in any court proceeding, the Commissioner must produce evidence of compliance with the supervisory approval requirement, even if the IRS does not bear the burden of proof.[512]

Description of Proposal

Certain contributions not treated as qualified conservation contributions

The proposal provides that certain charitable contributions made by a partnership in a conservation easement transaction will not be treated as qualified conservation contributions. The contribution will not be so treated if the amount of the contribution exceeds two and one-half times the sum of each partner's relevant basis in such partnership (the "disallowance rule"). A partner's relevant basis is the portion of the partner's modified basis in the partnership[513] that is allocable[514] to the portion of the real property interest with respect to which the qualified conservation contribution is made.

The disallowance rule does not apply to contributions made after a three-year holding period. The holding period is satisfied if such contribution is made at least three years after the latest of: (1) the last date on which the partnership that made the contribution acquired any portion of the real property with respect to which the contribution was made; (2) the last date on which any partner in the partnership that made the contribution acquired any interest in the partnership; and (3) if the interest in the partnership making the contribution is held through one or more partnerships, the last date on which any such partnership acquired any interest in any other such partnership and the last date on which any partner in any such partnership acquired any interest in such partnership. The proposal also includes an exception for certain family partnerships.

Except as provided by the Secretary, rules similar to the rules in the proposal relating to qualified conservation contributions of partnerships apply to S corporations and other pass-through entities. The Secretary is directed to issue such regulations or other guidance as may be

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[511] Sec. 6751(b), generally. Other penalties exempt from the pre-approval requirement are penalties under sections 6651 (failure to file or pay taxes), 6654 (failure to pay estimated individual taxes), 6655 (failure to pay estimated corporate taxes), and section 6662(b)(9) (overstatement of the charitable deduction for nonitemizers provided in section 170(p)).

[512] *Graev v. Commissioner*, 149 T.C. 485 (2017). Cf. *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017) (held that the Commissioner bears both the burden of production and burden of proof with respect to the penalty).

[513] For this purpose, the partner's modified basis in the partnership means the partner's adjusted basis in the partnership as determined: (1) immediately before the contribution, (2) without regard to section 752 (relating to the treatment of certain liabilities), and (3) by the partnership after taking into acount the adjustments described in (1) and (2) and such other adjustments as the Secretary may provide.

[514] The allocable portion is determined under rules similar to the rules of section 755 (rules for allocation of basis).

necessary or appropriate to carry out or prevent avoidance of the purposes of the proposal, including reporting related to tiered partnerships and modified basis of partners.

The proposal makes several changes to the application of section 6662 accuracy related penalties in conservation easement cases. First, the proposal provides that the section 6662 accuracy-related penalty applies to any underpayment of tax attributable to the disallowance of a deduction by reason of the new limitation on qualified conservation contributions in this proposal. In addition, any such disallowance is treated as a gross valuation misstatement, which increases the amount of the accuracy-related penalty to from 20 percent to 40 percent of the underpayment of tax. No defense based on reasonable cause otherwise available to an accuracy-related penalty under section 6664(c) is available for any such underpayment. Finally, the requirement for supervisory approval of the penalty assessment under section 6751(b) does not apply.

The proposal also addresses the applicable statute of limitations for assessment of tax or penalties related to syndicated conservation easement transactions. First, for returns filed for partnership taxable years beginning before January 1, 2018, the assessment of tax is subject to the rules of former section 6229, under which the period in which the tax must be assessed against the partners does not expire before one year following the date on which a final partnership administrative adjustment may no longer be petitioned to the U.S. Tax Court or, if a petition was filed, the date on which a decision of the court with respect to such petition becomes final. The proposal extends this one-year period to two years. Second, in the case of any disallowance of a deduction by reason of the proposal, the transaction shall be treated as having been identified by the Secretary on December 23, 2016, as a tax avoidance transaction within the meaning of section 6011 for purposes of the statute of limitations rule described in sections 6501(c)(10) and 6235(c)(6). Finally, in the case of any disallowance of a deduction under section 170 for a transaction described in IRS Notice 2017-10, the disallowance will be treated as having been made by reason of the proposal for purposes of the penalty and statute of limitations provisions described above.

Notice of certain failures

The proposal allows certain taxpayers an opportunity to correct certain defects in a deed that grants an easement. If a donor is found by the Secretary to have failed to meet the requirement that a qualified conservation easement be granted and protected in perpetuity by reason of defective language in the deed relating to property line adjustments or extinguishment clauses, the donor has 90 days from the written notice by the Secretary to correct the failure, unless the Secretary can demonstrate that the donor’s failure was intentional. This rule does not apply to any transaction that is a reportable transaction or any other contribution that is not treated as a qualified conservation contribution by reason of the disallowance rule described above.

Effective Date

Except as provided below, the proposal is effective for contributions made after December 23, 2016 (the date of IRS Notice 2017-10), in taxable years ending after such date. For contributions of easements with a purpose of preserving a certified historic structure (as defined in section 170(h)(4)(C)), the proposal is effective for contributions made in taxable years beginning after December 31, 2018. No inference is intended as to the appropriate treatment of contributions made in taxable years ending on or before the applicable date specified above as to any activity not described in the relevant portion of the proposal.

The portion of the proposal that allows certain taxpayers to correct defects in a deed granting an easement is effective for (1) returns filed after the date of enactment and (2) returns filed on or before such date if the period of limitations specified in section 6501 for assessment of taxes with respect to which the return relates has not expired as of such date.

4. Modification of procedural requirements relating to assessment of penalties

Present Law

The Code includes multiple provisions governing the proper application of penalties and additions to tax. Under those provisions there are rules regarding the details required to be included in such notices, as well as limitations periods applicable to assertion of such additions to tax and penalties. The IRS also publishes guidance for the public and its employees on the administration of penalties in support of encouraging voluntary compliance, by requiring that penalties be administered in compliance with its general policy statement regarding the need for penalties to be based on merits and fairness to the taxpayer.[515]

Under the Code, assessment of an addition to tax or penalty is barred in the absence of prior supervisory approval. Such approval requires that the initial determination of the penalty or addition to tax be approved in writing by the immediate supervisor of the person asserting the penalty. The Code authorizes the Secretary to designate a higher-level official to provide the supervisory approval. Certain penalties are exempt from the requirement for supervisory approval, including those penalties "automatically calculated through electronic means."[516] Because the IRS bears the burden of producing evidence to support assessment of a penalty in any court proceeding, the Commissioner must produce evidence of compliance with the supervisory approval requirement, even if the IRS does not bear the burden of proof.[517]

[515] Sec. 6751, generally, and Policy Statement 20-1, outlining the obligations of managers and employees in evaluating assertion of penalties, noting, "This means that penalties are not a "bargaining point" in resolving the taxpayer's other tax adjustments. Rather, the imposition of penalties in appropriate cases serves as an incentive for taxpayers to avoid careless or overly aggressive tax reporting positions."

[516] Sec. 6751(b), generally. Other penalties exempt from the pre-approval requirement are penalties under sections 6651 (failure to file or pay taxes), 6654 (failure to pay estimated individual taxes) and 6655 (failure to pay estimated corporate taxes).

[517] *Chai v. Commissioner*, 851 F.3d 190 at 220-221 (2d Cir. 2017) (held that the Commissioner bears both the burden of production and burden of proof with respect to the penalty). Cf. *Graev v. Commissioner*, 149 T.C. 485 (2017).

Resulting litigation has established varying benchmarks or "consequential moments" for determining whether the IRS has satisfied the requirements.[518]

Description of Proposal

This proposal repeals the requirements for prior supervisory approval of penalties before assessment by the IRS. In its place, the proposal mandates that appropriate IRS supervisors certify quarterly to the Commissioner that they are in compliance with the statutory requirements of section 6751(a) and related policies of the IRS.

Effective Date

The repeal of the requirement for prior supervisory approval of assertion of penalties is effective as if included in section 3306 of the Internal Revenue Service Restructuring and Reform Act of 1998.[519]

The proposal for quarterly certification is effective for all notices of penalties issued after date of enactment.

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[518] See, Chief Counsel Notice 2018-006, published June 6, 2018, discussing various scenarios in which the provisions of subsection 6751(b) could be at issue. See *Chai v. Commissioner*, 851 F.3d as 220-221(referring to the task of deterining whether a specific scenario is a "consequential moment" in forming IRS position on asserting a penalty). See also *Beland v. Commissioner*, 156 T.C. No.5 (March 1, 2021) (granting taxpayer's motion for partial summary judgment that a fraud penalty was not timely where the supervisory approval was signed August 21, 2015, after a revenue agent report was provided to the taxpayer during a summons administration conference convened on August 19, 2015, citing the standards first articulated in *Chai* and *Graev, infra*, in 2017).

[519] Pub. L. 105-206, Title III.

J. Other Provisions

1. Modifications to limitation on deduction of excessive employee remuneration

Present Law

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense.[520] However, under section 162(m)(1),[521] in the case of a publicly held corporation, a deduction limit of $1 million generally applies to compensation of the principal executive officer or the three most highly compensated officers for the taxable year other than the principal executive officer. A corporation is treated as publicly held if it has a class of common equity securities that is requires to be registered under section 12 of the Securities Exchange Act of 1934.

Prior to the American Rescue Plan Act of 2021 ("ARPA"),[522] a "covered employee" was an employee who was (1) the principal executive officer, (2) principal financial officer, or (3) among the three most highly compensated officers for the taxable year (other than the principal executive officer or financial officer), defined in reference to the Exchange Act.[523] A covered employee also includes any individual who had met the criteria to be a covered employee since January 1, 2014. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to the principal executive officer, principal financial officer, and the three highest compensated officers.[524]

Unless specifically excluded, the deduction limitation applies to applicable employee renumeration,[525] which includes all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in section 280G) that are not deductible by the corporation. Compensation does not fail to be compensation with respect to a covered employee and thus subject to the deduction limit for a taxpayer year merely because the

[520] Sec. 162.

[521] Added to the Code by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, and amended by the Tax Cuts and Jobs Act, Pub. L. No. 115-97.

[522] Pub. L. No. 117-2, March 11, 2021.

[523] Notice 2007-49, 2007-25 I.R.B. 1429.

[524] Treas. Reg. sec. 1.162-27(c)(2).

[525] Sec. 162(m)(4).

compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death, or to a former spouse pursuant to a domestic relations order.

Prior to Public Law 115-97, certain types of compensation were excepted from the limit, including remuneration payable on a commission basis ("commission compensation") and, if certain outside director and shareholder approval requirements were met, remuneration payable solely on account of the attainment of one or more performance goals ("performance-based compensation"). The statute expanded the definition of compensation subject to the limit to include commission compensation and performance-based compensation in addition to other types of payments.

Section 162(m) was expanded by the ARPA to include five additional individuals as covered employees. This expansion was to take effect in taxable years beginning after December 31, 2026. Accordingly, up to ten individuals, including the principal executive officer, principal financial officer, and the next eight highest paid employees may be covered employees for purposes of section 162(m) after December 31, 2026.

Description of Proposal

The proposal accelerates the treatment of the five additional individuals as covered employees to December 31, 2021. Accordingly, up to ten individuals, including the principal executive officer, principal financial officer, and the next eight highest paid employees, may be covered employees for purposes of section 162(m) after December 31, 2021.

The proposal also modifies the definition of applicable employee remuneration[526] to be, except as otherwise provided, the aggregate amount allowable as a deduction for such taxable year for remuneration for services by the covered employee, including performance-based compensation, commissions, post-termination compensation, and beneficiary payments, whether or not such remuneration is paid directly by the publicly held corporation.

The proposal adds an aggregation rule requiring two or more persons who are treated as a single employer under section 414[527] to be treated as a single employer. For purposes of this determination, the brother-sister-controlled group[528] and combined group[529] rules under section 1563(a) shall be disregarded.

The Secretary will prescribe regulations or other guidance as may be necessary to carry out the purposes of paragraph (1), including regulations or other guidance to prevent the

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[526] Sec. 162(m)(4)(A).

[527] Subsections (b), (c), (m), or (o) of Sec. 414.

[528] Sec. 1563(a)(2).

[529] Sec. 1563(a)(3).

avoidance of the proposal, including through the performance of services other than as an employee or by providing compensation through a passthrough or other entity.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

2. Extension of tax to fund the Black Lung Disability Trust Fund

Present Law

Coal extracted from mines is taxed at either $1.10 per ton if from an underground mine or $0.55 per ton if from a surface mine.[530] The total amount of tax is not to exceed 4.4 percent of the price at which such ton of coal was sold by the producer.

After December 31, 2021, the "temporary increase termination date," the tax rates decline to rates of $0.50 for underground mines and $0.25 for surface mines. After the temporary increase termination date, the total amount of tax is not to exceed two percent of the price at which such ton of coal is sold by the producer.

Description of Proposal

The proposal extends the coal excise tax through December 31, 2025.

Effective Date

The proposal is effective for sales after December 31, 2021.

3. Prohibited transactions relating to holding DISC or FSC in individual retirement account

Present Law

Individual retirement arrangements

An individual retirement arrangement ("IRA") is a tax-favored savings arrangement under which retirement savings are held in a tax-exempt trust, custodial account, or annuity contract until distributed. The term includes both individual retirement accounts[531] and individual retirement annuities.[532] In addition, IRAs fall into two categories based on the timing of income inclusion: traditional IRAs,[533] to which both deductible and nondeductible

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[530] Sec. 4121.

[531] Sec. 408(a).

[532] Sec. 408(b).

[533] Sec. 408.

contributions may be made,[534] and Roth IRAs, to which only nondeductible contributions may be made.[535] For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) but, if certain requirements are satisfied, distributions are not includible in gross income.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($6,000 for 2021); and (2) the amount of the individual's compensation that is includible in gross income for the year.[536] In the case of an individual who has attained age 50 by the end of the year, the dollar amount is increased by $1,000. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount.

An individual may make contributions to a traditional IRA (up to the contribution limit) without regard to his or her adjusted gross income. An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual or the individual's spouse is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels.[537] In order to be eligible to make contributions to a Roth IRA, an individual's adjusted gross income must be below certain levels.[538]

<u>Prohibited transactions</u>

The Code prohibits certain transactions ("prohibited transactions") between a plan, including an IRA, and a disqualified person.[539] Disqualified persons include a fiduciary of the plan; a person providing services to the plan; an employer with employees covered by the plan; an employee organization any of whose members are covered by the plan; certain owners,

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[534] Sec. 219.

[535] Sec. 408A.

[536] Sec. 219(b)(2) and (5), as referenced in secs. 408(a)(1) and (b)(2)(B) and 408A(c)(2). Under section 4973, IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn.

[537] Sec. 219(g).

[538] Sec. 408A(c)(3).

[539] Sec. 4975. In addition to IRAs, these rules apply to qualified retirement plans, Archer MSAs, HSAs, and Coverdell ESAs. Sec. 4975(e)(1). Similar rules apply to certain plans under the Employee Retirement Income Security Act of 1974.

officers, directors, highly compensated employees,[540] family members, and related entities.[541] A fiduciary includes any person who (1) exercises any discretionary authority or discretionary control respecting management of the plan or exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (3) has any discretionary authority or discretionary responsibility in the administration of the plan.[542]

Prohibited transactions include the following transactions, whether direct or indirect, between a plan and a disqualified person: (1) the sale or exchange or leasing of property; (2) the lending of money or other extension of credit; (3) the furnishing of goods, services, or facilities; (4) the transfer to, or use by or for the benefit of, the income or assets of the plan; (5) in the case of a fiduciary, an act dealing with the plan's income or assets in the fiduciary's own interest or for the fiduciary's own account; and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.[543]

Sanctions for violations

Under the Code, if a prohibited transaction occurs, the disqualified person who participated in the transaction is generally subject to a two-tiered excise tax. The first tier tax is 15 percent of the amount involved in the transaction. The second tier tax, imposed if the prohibited transaction is not corrected within a certain period, is 100 percent of the amount involved.

A special rule applies in the case of certain prohibited transactions involving IRAs. If an individual for whose benefit an IRA is established (or such individual's beneficiary) engages in a prohibited transaction with respect to the IRA, the IRA loses its tax-favored status and ceases to be an IRA as of the first day of the taxable year in which the prohibited transaction occurs.[544] As a result, the IRA is treated as distributing to the individual on the first day of that taxable year the fair market value of all of the assets in the account. If the fair market value of the IRA assets exceeds the basis in the account, the individual has taxable gain that is includible in gross income. If the individual is under age 59½, the individual may also be subject to the 10-percent

[540] Within the meaning of section 414(q).

[541] Sec. 4975(e)(2).

[542] Sec. 4975(d)(3).

[543] Sec. 4975(c)(1)(A)-(F).

[544] Sec. 408(e)(2). Similar rules apply in the case of certain prohibited transactions involving an HSA, Archer MSA, or Coverdell ESA.

tax on early distributions.[545] The individual and the individual's beneficiaries are exempt, however, from the excise tax that otherwise applies to prohibited transactions.[546]

IRS guidance on abusive Roth IRA transactions

In 2004, the IRS released guidance describing certain Roth IRA transactions that the agency identifies as tax avoidance transactions that must be reported to the IRS as listed transactions.[547] The notice describes the transactions as generally involving (1) a taxpayer who owns a pre-existing business such as a corporation or sole proprietorship (the "Business"), (2) a Roth IRA maintained for the taxpayer, and (3) a corporation substantially all the shares of which are owned or acquired by the Roth IRA ("Roth IRA Corporation"). The Roth IRA Corporation and the Business or the taxpayer[548] enter into a transaction or arrangement that has the effect of transferring value to the Roth IRA Corporation comparable to a contribution to the Roth IRA. Examples of such transactions under the notice include transactions in which the Roth IRA Corporation acquires property, such as accounts receivable, from the Business for less than fair market value, or contributions of property, including intangible property, by a person other than the Roth IRA, without a commensurate receipt of stock ownership.

The notice provides that such transactions are designed to avoid the statutory limits on contributions to a Roth IRA, and states further that because the taxpayer in these arrangements controls the Business and is the beneficial owner of substantially all of the Roth IRA Corporation, the taxpayer is in a position to shift value from the Business to the Roth IRA Corporation. The notice provides that the Secretary will challenge the tax benefits resulting from these transactions.

Interest charge domestic international sales corporations ("IC-DISC")[549]

The U.S. tax system has had various provisions intended to ameliorate disadvantages that U.S. multinational enterprises may face in competing with entities based in jurisdictions that based their tax regimes on territorial principles to a greater extent than the United States did prior to 2018. By exempting foreign-source income to varying degrees, the tax systems of other countries arguably provide a competitive advantage for their exports (as well as other foreign-related business activities of their residents). The DISC and FSC regimes were designed to address that disparity. The FSC regime was later repealed and replaced by the extraterritorial income systems ("ETI") in 2000, with transition rules that allowed continued existence of

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[545] Sec. 72(t).

[546] Sec. 4975(c)(3).

[547] Notice 2004-8, 2004-4 I.R.B. 333, January 26, 2004. A listed transaction is a transaction that is the same or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. Treas. Reg. sec. 1.6011-4(b)(2). Every taxpayer that has participated in such a transaction and who is required to file a tax return must file a disclosure statement disclosing such transaction.

[548] Including related parties described in section 267(b) or 707(b).

[549] Secs. 991 through 997.

certain FSCs.[550] Only a modified version of the DISC regime remains in effect, as described below.

Under the IC-DISC regime, certain domestic corporations are exempt from Federal corporate income tax on their export income, with partial deferral of tax for its shareholders. In general, the IC-DISC is not subject to corporate-level Federal income tax.[551] To qualify as an IC-DISC, a domestic corporation must have a valid election (to which all shareholders consent) to be taxed as a IC-DISC[552] and satisfy the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets; the corporation must have no more than one class of stock; and the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year.[553]

The U.S. tax system has had a series of special tax regimes intended to provide incentives for foreign trade, including the DISC regime and foreign sales corporations ("FSC"). Benefits of the DISC regime were curtailed when the FSC regime was enacted in 1984. The FSC regime was repealed and replaced by the extraterritorial income systems ("ETI") in 2000, with transition rules that allowed continued existence of certain FSCs.[554] These regimes were intended to

[550] Former secs. 921 through 927 (FSC); former secs. 941-943. See section 2, *The FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, Pub. L. No. 106-519, which provided that no new FSCs could be created, terminated inactive FSCs, but allowed an election to be treated as a domestic corporation under former section 943. With the repeal of the ETI provisions in 2004, further transition rules were provided for transactions in taxable years 2005 and 2006. Sec. 101(b)(2), *American Jobs Creation Act of 2004*, Pub. L. No. 108-357. Earlier efforts included the special rules and benefits for China Trade Corporations and Western Hemisphere Corporations under the Code of 1939, in addition to the partial deferral for DISCS under the Internal Revenue Code of 1954. Prior to being supplanted by FSCs, DISCs were eligible for more generous tax benefits. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 1066.

For an overview of the history of various special regimes and the trade disputes they engendered, see Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 81. (Fourth Ed. 2016). See also, *Joint Committee on Taxation, The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

[551] Sec. 991.

[552] See Form 4876-A, *Election to be Treated as an Interest-Charge DISC*.

[553] Secs. 992(a) and (b). If a corporation fails to satisfy either or both 95-percent tests, it may be deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. Sec. 992(c).

[554] Former secs. 921 through 927 (FSC); former secs. 941-943. See section 2, *The FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, Pub. L. No. 106-519, which provided that no new FSCs could be created, terminated inactive FSCs, but allowed an election to be treated as a domestic corporation under former section 943. With the repeal of the ETI provisions in 2004, further transition rules were provided for transactions in taxable years 2005 and 2006. Sec. 101(b)(2), *American Jobs Creation Act of 2004*, Pub. L. No. 108-357. Earlier efforts included the special rules and benefits for China Trade Corporations and Western Hemisphere Corporations under the Code of 1939, in addition to the partial deferral for DISCS under the Internal Revenue Code of 1954.

ameliorate disadvantages that U.S. multinational enterprises may face in competing with entities based in jurisdictions that based their tax regimes on territorial principles to a greater extent than the United States did prior to 2018. By exempting foreign-source income to varying degrees, the tax systems of other countries arguably provide a competitive advantage for their exports (as well as other foreign-related business activities of their residents). Only a modified version of the DISC regime remains in effect, as described below.

Under the IC-DISC regime, certain domestic corporations are exempt from Federal corporate income tax on their export income, with partial deferral of tax for its shareholders. In general, the IC-DISC is not subject to corporate-level Federal income tax.[555] To qualify as an IC-DISC, a domestic corporation must have a valid election (to which all shareholders consent) to be taxed as a IC-DISC[556] and satisfy the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets; the corporation must have no more than one class of stock; and the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year.[557]

While an election is in effect, it applies to each shareholder who owns stock in the corporation. Personal holding companies, corporations exempt from tax under section 501, regulated investment companies, insurance companies, and S corporations are ineligible to be treated as IC-DISCs.[558] An IC-DISC is not required to have its own employees, offices or equipment. It need only have a bank account and be maintained as a separate accounting entity.[559]

Shareholders are generally not required to pay tax on undistributed taxable income of the IC-DISC to the extent that the taxable income is attributable to no more than $10 million qualified export receipts annually. Instead, shareholders must pay an interest charge to account for the benefit of deferring the tax liability on undistributed IC-DISC income. The shareholders of a corporation that is not currently an IC-DISC but was in a previous taxable year and has

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Prior to being supplanted by FSCs, DISCs were eligible for more generous tax benefits. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 1066.

For an overview of the history of various special regimes and the trade disputes they engendered, see Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 81. (Fourth Ed. 2016). See also, *Joint Committee on Taxation, The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

555 Sec. 991.

556 See Form 4876-A, *Election to be Treated as an Interest-Charge DISC*.

557 Secs. 992(a) and (b). If a corporation fails to satisfy either or both 95-percent tests, it may be deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. Sec. 992(c).

558 Sec. 992(d).

559 Treas. Reg. sec. 1.992-1(a)(7).

previously-taxed income or accumulated IC-DISC income, are also required to pay interest on the deferral benefit. Gain on the sale or exchange of stock in such corporation is treated as a dividend.[560]

The deferral benefit is the excess of the amount of tax for which the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. The rate is the average of one-year constant maturity Treasury yields.[561]

Shareholders of an IC-DISC are subject to tax on actual distributions as well as certain items of DISC income that are treated as deemed distributions for the taxable year. Distributions treated as dividends are qualified dividends eligible for the rate applicable to net capital gains.[562] Corporations are not eligible for a dividends-received deduction on any distributions received by an IC-DISC.[563] All such gains and distributions are treated

Most IC-DISC deemed distributions[564] are comprised of interest on producer's loans (defined in section 993(d)); gains on the sale or exchange of property (other than qualified export property) previously acquired by the IC-DISC in a tax-free transaction; 50 percent of the taxable income of the IC-DISC attributable to military property; taxable income attributable to qualified export receipts that exceed $10,000,000;[565] and, if the shareholder is a C corporation, 1/17th of the taxable income during the year (after accounting for the items above, but before accounting for any actual distributions made).

The amount of deemed distributions cannot exceed the IC-DISC's earnings and profits for any given year, even if the IC-DISC has accumulated earnings and profits.[566] Since a shareholder does not actually receive a constructive dividend, the shareholder's basis in the IC-DISC is increased by the amount of the dividend.[567] When that portion of the IC-DISC's previously taxed income is actually distributed to the shareholder, this income is not taxed to the shareholder, and reduces the shareholder's basis in the IC-DISC. To the extent such a

[560] Sec. 995(c)(1)(B).

[561] Sec. 995(f).

[562] Secs. 995(a) and (b); sec. 1(h)(11) provides a tax rate of 15 percent for individuals.

[563] Sec. 246(d).

[564] The full list can be found in section 995(b)(1).

[565] Sec. 995(b)(4). The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of $10 million. For purposes of this calculation, multiple IC-DISCs that are part of the same controlled group are treated as one corporation (which has the effect of aggregating their receipts).

[566] Treas. Reg. sec. 1.995-2(b).

[567] Sec. 996(e).

distribution exceeds the shareholder's basis, it is treated as gain on the sale or exchange of property.[568]

Any actual distribution is considered to be distributed first out of previously taxed income, then from accumulated tax deferred income, and then from all other earnings and profits.[569] Gain on the sale of IC-DISC stock is treated as a dividend to the extent of accumulated IC-DISC income.[570]

Description of Proposal

The proposal amends the definition of prohibited transaction to include an individual retirement account that holds an interest in a DISC[571] or FSC[572] that receives any commission or other payment from an entity any stock or interest in which is owned by the individual for whose benefit the individual retirement account is maintained. For this purpose, if an individual retirement account holds an interest in an entity that owns, directly or indirectly, an interest in a DISC or FSC, the account is treated as holding an interest in such DISC or FSC.

Constructive ownership rules under the Code apply in determining ownership of stock or interest in the entity making commissions or payments to the DISC or FSC, as well as in determining ownership of a DISC or FSC by an entity in which the individual retirement account holds an interest.[573] However, for purposes of the proposal, the constructive ownership rules relating to attribution of ownership to corporations apply based on 10 percent, rather than 50 percent, ownership in such corporation.[574]

The proposal also provides that the exception from the excise tax that applies to prohibited transactions involving an IRA that loses its tax-favored status does not apply in the case of the prohibited transaction added by the proposal. Thus, if the owner of an individual retirement account engages in a prohibited transaction involving a DISC or FSC, as described in the proposal, the individual retirement account will lose its tax-favored status (and be treated as distributing its assets as of the first day of the taxable year), and excise taxes will also apply.

[568] Sec. 996(e).

[569] Sec. 996(a).

[570] Sec. 995(c).

[571] Sec. 992(a)(1).

[572] Sec. 922(a), as in effect before its repeal by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. All references to FSC include electing "small FSC" entities under section 922(b).

[573] Sec. 318.

[574] Sec. 318(a)(2)(C) and (3)(C).

Effective Date

The proposal applies to stock and other interests acquired or held on or after December 31, 2021.

4. Increase in tax on certain tobacco products, imposition of tax on nicotine, and clarification of rules regarding tobacco drawback

Present Law

Federal excise taxes are imposed upon various types of tobacco products and cigarette papers and tubes.[575] "Tobacco products" are cigars, cigarettes, smokeless tobacco, pipe tobacco, and roll-your-own tobacco.[576]

A "cigar" is any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco, other than any roll of tobacco which is a cigarette.[577]

A "cigarette" is (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; and (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette.[578]

"Smokeless tobacco" is any snuff or chewing tobacco.[579] "Snuff" is finely cut, ground or powdered tobacco that is not intended to be smoked.[580] "Chewing tobacco" is any leaf tobacco that is not intended to be smoked.[581]

"Pipe tobacco" is any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe.[582]

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[575] Sec. 5701.

[576] Sec. 5702(c).

[577] Sec. 5702(a).

[578] Sec. 5702(b).

[579] Sec. 5702(m)(1).

[580] Sec. 5702(m)(2).

[581] Sec. 5702(m)(3).

[582] Sec. 5702(n).

"Roll-your-own tobacco" is any tobacco, which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes.[583]

"Cigarette paper" is paper, or any other material except tobacco, prepared for use as a cigarette wrapper. A "cigarette tube" is cigarette paper made into a hollow cylinder for use in making cigarettes.[584]

The following table lists the tax rates on tobacco products and cigarette papers and tubes.

Tobacco Product	Present Law Tax Rates
"Small cigars" (weighing three pounds or less per thousand)[1]	$50.33 per thousand
"Large cigars" (weighing more than three pounds per thousand)[2]	52.75 percent of manufacturer's sale price, but not more than 40.26 cents per cigar
"Small cigarettes" (weighing three pounds or less per thousand)[3]	$50.33 per thousand
"Large cigarettes" (weighing more than three pounds per thousand)[4]	$105.69 per thousand
Snuff[5]	$1.51 per pound[6]
Chewing tobacco[7]	50.33 cents per pound
Pipe tobacco[8]	$2.8311 per pound
Roll-your-own tobacco[9]	$24.78 per pound

[583] Sec. 5702(o).

[584] Sec. 5702(f).

Tobacco Product	Present Law Tax Rates
Cigarette papers[10]	3.15 cents for each 50 papers (or fractional part thereof)
Cigarette tubes[11]	6.30 cents for each 50 tubes (or fractional part thereof)

[1] Sec. 5701(a)(1).

[2] Sec. 5701(a)(2).

[3] Sec. 5701(b)(1).

[4] Large cigarettes more than 6.5 inches in length are taxed as small cigarettes, counting each 2.75 inches (or fraction thereof) of the length of each as one cigarette. Sec. 5701(b)(2).

[5] Sec. 5701(e)(1).

[6] Each of the tax rates on snuff, chewing tobacco, pipe tobacco, and roll-your-own tobacco is applied proportionately to fractional parts of a pound.

[7] Sec. 5701(e)(2).

[8] Sec. 5701(f).

[9] Sec. 5701(g).

[10] Cigarette papers measuring more than 6.5 inches in length are taxed at the rate prescribed, counting each 2.75 inches (or fraction thereof) of the length of each as one cigarette paper. Sec. 5701(c).

[11] Cigarette tubes measuring more than 6.5 inches in length are taxed at the rate prescribed, counting each 2.75 inches (or fraction thereof) of the length of each as one cigarette tube. Sec. 5701(d).

The excise tax liability arises when the tobacco products or cigarette papers and tubes are manufactured or imported, but the requirement to pay the tax is not triggered until the product is removed from the taxpayer's premises or, in the case of an imported product, from customs custody or bond.[585] The tax is determined and paid at the time of removal unless the taxpayer has a deferral bond in place, in which case the taxes are paid on the basis of semi-monthly return periods.[586] Any taxpayer who is liable for a gross amount of taxes equal to or exceeding $5,000,000 during a calendar year must make deposits of tax for the following year by electronic funds transfer.[587]

Transfer rules and removals without tax

Tobacco products and cigarette papers and tubes may be transferred between bonded premises of manufacturers of tobacco products and export warehouse proprietors without payment of the tax; the transferee is liable for the tax on the transferred tobacco products and papers and tubes.[588] Tobacco products and cigarette papers and tubes may also be removed without payment of tax for exportation; the exporter is relieved from the tax once proof of

[585] Sec. 5703.

[586] Sec. 5703(b).

[587] Sec. 5703(b)(3).

[588] Sec. 5703(a) and 5704.

exportation is obtained.[589] Tax-paid product exported from the United States is eligible for drawback of the tax under certain conditions.[590] Imported tobacco products may be released from customs custody in bulk for transfer to the bonded premises of a manufacturer or export warehouse proprietor without payment of the tax; the transferee is then responsible for the taxes.[591] Generally, previously exported domestic tobacco products may be relanded[592] in the United States only if they are transferred to the original manufacturer or to an export warehouse proprietor authorized by the original manufacturer.[593] To prevent the diversion of tobacco products destined for export without payment of tax, however, packages bearing export marks are not allowed in the domestic marketplace.[594] The tax is refunded or credited (without interest) for products withdrawn from the market and returned to bonded premises.[595] Tax-paid products that are lost by casualty or certain disasters are eligible for tax refunds or credits.[596]

Permits and bonds

Manufacturers and importers of tobacco products, processed tobacco, and proprietors of export warehouses must obtain permits to engage in such businesses.[597] A permit is obtained by application to the Secretary. The Secretary may deny the application if (1) the business premises are inadequate to protect the revenue; (2) the activity to be carried out at the business premises does not meet such minimum capacity or activity requirements as prescribed by the Secretary; (3) the applicant is, by reason of his business experience, financial standing, or trade connections, not likely to maintain operations in compliance with the applicable provisions of the Code; (4) the applicant has been convicted of a felony violation of Federal or state criminal law relating to tobacco products, processed tobacco, cigarette paper, or cigarette tubes; or (5) the applicant has failed to disclose any material information required or made any material false statement in the application. In the case of a corporation, an applicant includes any officer, director, or principal stockholder and, in the case of a partnership, a partner.[598]

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[589] Sec. 5704(b).

[590] Sec. 5706.

[591] Sec. 5704(c).

[592] A good is relanded if it is marked for export, but is returned to the United States without payment of duty. See 18 U.S.C. sec. 544.

[593] Secs. 5754 and 5761(c).

[594] Secs. 5754(a) and 5761(c).

[595] Sec. 5705.

[596] Secs. 5705 and 5708.

[597] Sec. 5713(a).

[598] Sec. 5712.

A permit is conditioned upon compliance with relevant provisions of the Code and related regulations pertaining to tobacco products and cigarette papers and tubes. The Secretary may suspend or revoke a permit after a notice and hearing if the holder (1) has not in good faith complied with those rules or has violated any other provision of the Code involving intent to defraud; (2) has violated the conditions of the permit; (3) has failed to disclose any material information required or made any material false statement in the permit application; (4) has failed to maintain the business premises in such a manner as to protect the revenue; (5) is, by reason of previous or current legal proceedings involving a felony violation of any other provision of Federal criminal law relating to tobacco products, processed tobacco, cigarette paper, or cigarette tubes, not likely to maintain operations in compliance with the applicable provisions of the Code; or (6) has been convicted of a felony violation of Federal or state criminal law relating to tobacco products, processed tobacco, cigarette paper, or cigarette tubes.[599]

A surety bond is required to be furnished by manufacturers of tobacco products or cigarette papers and tubes and export warehouse proprietors before they commence business.[600] Importers are not required to post a surety bond because the requirement to pay the tax is triggered at the time the tobacco products or cigarette papers or tubes are released from customs custody. Prior to that time, the customs bond is applicable.

Occupational tax

An occupational tax of $1,000 per year is imposed on manufacturers of tobacco products, cigarette papers and tubes, and export warehouse proprietors.[601] A reduced rate of $500 per year applies to taxpayers with excise tax liability in the prior year of less than $500,000.[602] Controlled groups are treated as a single person. Any person engaged in business subject to the occupational tax who willfully fails to pay the tax imposed is subject to a fine of not more than $5,000 or imprisonment of not more than two years, or both, for each such offense.[603]

Miscellaneous rules, including operational, reporting, and recordkeeping requirements

Before removal, tobacco products, processed tobacco, and cigarette papers and tubes must be in packages and bear such marks, labels, and notices as required by the regulations.[604]

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[599] Sec. 5713.

[600] Sec. 5711.

[601] Sec. 5731(a).

[602] Sec. 5731(b).

[603] Sec. 5731(c).

[604] Secs. 5723(a) and (b).

The Code prohibits lottery features and indecent or immoral material from being contained in or attached to a package of tobacco products or cigarette papers or tubes.[605]

Manufacturers, importers, and export warehouse proprietors are required to keep records, file operating reports, and make accurate inventories as required by regulations.[606] Tobacco products may be furnished by a manufacturer to its employees or put to experimental use without payment of tax under conditions set forth in regulations.[607]

Fines and penalties

The Code contains provisions relating to the purchase, receipt, possession, sale, or disposal of certain tobacco products and cigarette papers and tubes.[608] It also imposes restrictions on importation of previously exported tobacco products.[609] Civil and criminal penalties and forfeiture provisions apply for failure to comply with the tobacco provisions.[610] The criminal and forfeiture provisions of subtitle F of the Code that apply to taxes in general also apply to tobacco taxes.

Civil penalties apply to certain actions including the willful failure to comply with the duties imposed (such as recordkeeping and labeling), failure to pay tax, and for the illegal sale of tobacco products.[611] Criminal penalties apply to certain actions including engaging in business unlawfully, failing to furnish certain information or furnishing false or fraudulent information, tax evasion, unlawful removal of tobacco products or cigarette papers or tubes, and for purchasing, receiving, possessing, or selling tobacco products or cigarette papers or tubes unlawfully.[612] Tobacco products and cigarette papers and tubes are subject to forfeiture if they are possessed with the intent to defraud the United States, or are not in packaging as required under the law.[613] Additional property may also be subject to forfeiture if it is used to engage in the manufacturing business unlawfully, or if the proprietor makes false or fraudulent records or reports with the intent to defraud the United States. Certain forfeited, condemned, or abandoned

[605] Secs. 5723(c) and (d).

[606] Secs. 5721, 5722 and 5741.

[607] Sec. 5704(a).

[608] Sec. 5751.

[609] Sec. 5754.

[610] Secs. 5751-52 and 5761-63.

[611] Sec. 5761.

[612] Sec. 5762.

[613] Sec. 5763.

tobacco products or cigarette papers and tubes may be disposed of in accordance with regulations.[614]

Description of Proposal

The proposal increases the Federal excise taxes on tobacco products. The tax rates for cigarette papers and tubes are unchanged.

The proposal changes the form of the tax on large cigars from a tax on percentage of sales price to a tax per pound,[615] with a minimum tax per cigar. The proposal delegates to the Secretary or the Secretary's delegate the authority to determine the appropriate method for determining the weight of large cigars for purposes of the tax. The proposed tax rate for large cigars is $49.56 per pound with a min. tax of 10.06 cents per cigar.

The proposal also adds discrete single-use units to the definition of smokeless tobacco. A "discrete single use unit" is any product containing tobacco that (1) is not intended to be smoked, and (2) is in the form of a lozenge, tablet, pill, pouch, dissolvable strip, or other discrete single-use or single-dose unit. The proposed tax rate for discrete single-use units is $100 per thousand.[616]

The proposal modifies the definition of "roll your own tobacco" to include processed tobacco that is removed for delivery or delivered to a person other than a person with a permit.[617]

The proposal also imposes a new excise tax on taxable nicotine. The amount of tax is the greater of (i) the dollar amount specified for small cigarettes or (ii) $100.66 per 1,810 milligrams of nicotine (and a proportionate tax on any fractional part thereof).

The proposal defines taxable nicotine as any nicotine which has been extracted, concentrated, or synthesized. However, the definition excludes any nicotine if the manufacturer or importer demonstrates to the satisfaction of the Secretary of Health and Human Services that such nicotine will be used in a drug which has been approved by the Food and Drug Administration for sale as a nicotine replacement therapy. Additionally, other tobacco products that are currently subject to tax will not be treated as containing taxable nicotine solely because of any concentration of nicotine naturally occurring in such products or any addition of nicotine to such products during the manufacturing process.

Under the proposal, taxable nicotine is treated as a tobacco product. General provisions that apply to tobacco products, such as (i) packaging requirements, (ii) provisions relating to

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[614] Sec. 5753.

[615] Under the proposal, the tax rate for large cigars is applied proportionately to fractional parts of a pound.

[616] The definitions of snuff and chewing tobacco are amended to exclude discrete single-use units.

[617] The definition excludes removals of processed tobacco for exportation as well as removals for delivery to permitted persons engaged in businesses as a manufacturer or importer of tobacco products or processed tobacco or as an export warehouse proprietor.

purchase, receipt, possession, or sale, and (iii) provisions relating to civil and criminal penalties, apply to taxable nicotine.

Additionally, the proposal provides that references in the Code to a manufacturer of tobacco products or to manufacturing tobacco products include references to a manufacturer of taxable nicotine or to manufacturing taxable nicotine, respectively. Therefore, a manufacturer of taxable nicotine is subject to the occupational tax and other requirements that apply to manufacturers of tobacco products. Under the proposal, a manufacturer of taxable nicotine includes any person who extracts, concentrates, or synthesizes nicotine.

The proposal requires the Secretary to prescribe regulations or other guidance as necessary or appropriate, including regulations or other guidance for coordinating the taxation of tobacco products and taxable nicotine to protect revenue and prevent double taxation.

Under the proposal, the Federal excise taxes on tobacco products (including taxable nicotine) and cigarette papers and tubes are:

Tobacco Product	**Current Tax**	**Proposed Tax**
"Small cigars"	$50.33 per thousand	$100.66 per thousand
"Large cigars"	52.75 percent of manufacturer's sale price, but not more than 40.26 cents per cigar	$49.56 per pound, with a min. tax of 10.06 cents per cigar
"Small cigarettes"	$50.33 per thousand	$100.66 per thousand
"Large cigarettes"	$105.69 per thousand	$211.39 per thousand
Snuff	$1.51 per pound	$26.84 per pound
Chewing tobacco	50.33 cents per pound	$10.70 per pound
Discrete single-use unit	*Not applicable*	$100 per thousand
Pipe tobacco	$2.8311 per pound	$49.56 per pound
Roll-your-own tobacco	$24.78 per pound	$49.56 per pound
Cigarette papers	3.15 cents for each 50 papers (or fractional part thereof)	*Unchanged*
Cigarette tubes	6.30 cents for each 50 tubes (or fractional part thereof)	*Unchanged*
Taxable nicotine	*Not applicable*	$100.66 per 1,810 milligrams of nicotine

Under the proposal, the Federal excise tax dollar amounts are adjusted for inflation for calendar years beginning after 2022.

The proposal imposes a floor stock tax on covered tobacco products and cigarette papers and tubes manufactured in or imported into the United States which are removed before the effective date and held for sale on such date by any person. The amount of the tax is (1) the tax that would be imposed under section 5701 if the article had been removed on the effective date less (2) any prior tax imposed under section 5701. Covered tobacco products are tobacco products other than cigars, discrete single-use units, and taxable nicotine. Covered tobacco products and cigarette papers and tubes which are located in a foreign trade zone on the effective date are subject to the floor stock tax if (1) internal revenue taxes have been determined, or customs duties liquidated, with respect to such articles before the effective date, pursuant to a request under the Foreign Trade Zone Act,[618] or (2) such articles are held on the effective date under the supervision of a customs officer.

The proposal provides a transition rule for permit and bond requirements. A person who is lawfully engaged in business as a manufacturer or importer of taxable nicotine, first becomes subject to such requirements by reason of the amendments under the proposal, and submits an application to engage in such business not later than 90 days after the date of the enactment, will not be denied the right to carry on such business by reason of such requirements before final action on such application.

Finally, the proposal amends the drawback rules under section 5706 to provide that an exemption from tax under section 5704 is a drawback, and no further drawback will be allowed based on merchandise that has not been subject to tax.[619]

Effective Date

The proposal generally applies to articles removed in calendar quarters beginning after the date of enactment.

The proposals to modify the tax treatment of large cigars, impose a tax on discrete single-use units, and impose a tax on taxable nicotine apply to articles removed in calendar quarters beginning 180 days after the date of enactment.

The proposal with respect to drawbacks applies to drawback claims made on or after December 18, 2018.

5. Termination of employer credit for paid family and medical leave

Present Law

In general

The Family and Medical Leave Act of 1993, as amended (the "FMLA"), generally requires employers to provide employees with up to 26 weeks of leave under certain

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[618] 19 U.S.C. 81a *et seq*.

[619] The proposal provides that this change will not be construed to create any inference with respect to any drawback claim made before December 18, 2018.

circumstances.[620] In general, FMLA does not require that the employer continue to pay employees during such leave, although employers may choose to pay for all or a portion of such leave. State and local governments may provide, or State and local laws may require employers to provide, employees with up to a certain amount of paid leave for types of leave that may or may not fall under the FMLA.

Employer credit for paid family and medical leave

Eligible employers can claim a general business credit equal to 12.5 percent of the amount of eligible wages (based on the normal hourly wage rate) paid to "qualifying employees" during any period in which such employees are on "family and medical leave" if the rate of payment under the program is 50 percent of the wages normally paid to an employee for actual services performed for the employer.[621] The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent. The maximum amount of family and medical leave that may be taken into account with respect to any qualifying employee for any taxable year is 12 weeks.

An "eligible employer" is one which has in place a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and which allows all less-than-full-time qualifying employees a commensurate amount of leave (on a *pro rata* basis) compared to the leave provided to full-time employees. The policy must also provide that the rate of payment under the program is not less than 50 percent of the wages normally paid to any such employee for services performed for the employer.

In addition, in order to be an eligible employer, the employer is prohibited from certain practices or acts which are also prohibited under the FMLA, regardless of whether the employer is subject to the FMLA. Specifically, the employer must provide paid family and medical leave in compliance with a written policy that ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.

A "qualifying employee" means any individual who is an employee under tax rules and principles and is defined in section 3(e) of the Fair Labor Standards Act of 1938,[622] as amended, who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold in such year for highly compensated employees.[623] For 2021, this 60 percent amount is $78,000.

[620] Pub. L. No. 103-3, Feb. 5, 1993.

[621] Wages for this purpose are Federal Unemployment Tax Act wages defined in section 3306(b), without regard to the dollar limitation, but do not include amounts taken into account for purposes of determining any other credit under subpart D of the Code.

[622] Pub. L. No. 75-718.

[623] Sec. 414(q)(1)(B) ($130,000 for 2021).

"Family and medical leave" for purposes of new section 45S is generally defined as leave described under sections 102(a)(1)(A)-(E) or 102(a)(3) of the FMLA.[624] If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave[625] (unless the medical or sick leave is specifically for one or more of the "family and medical leave" purposes defined above), such paid leave would not be considered to be family and medical leave. In addition, leave paid for by a State or local government or required by State or local law (including such leave required to be paid by the employer) is not taken into account in determining the amount of paid family and medical leave provided by the employer that is eligible for the credit. Any wages for paid sick or expanded family and medical leave taken into account for the payroll tax credit on such wages are not taken into account for purposes of determining the employer credit for certain paid family and medical leave under section 45S.[626]

The Secretary will make determinations as to whether an employer or an employee satisfies the applicable requirements for an eligible employer or qualifying employee, based on information provided by the employer that the Secretary determines to be necessary or appropriate.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020[627] extended the employer credit for paid family and medical leave so that it would expire on December 31, 2025.

Description of Proposal

The proposal amends the expiration date of the credit for paid family and medical leave from December 31, 2025[628] to December 31, 2023.

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[624] FMLA section 102(a)(1) provides leave for FMLA purposes due to (A) the birth of a son or daughter of the employee and in order to care for such son or daughter; (B) the placement of a son or daughter with the employee for adoption or foster care; (C) caring for the spouse, or a son, daughter, or parent, of the employee, if such spouse, son, daughter, or parent has a serious health condition; (D) a serious health condition that makes the employee unable to perform the functions of the employee's position; (E) any qualifying exigency (as the Secretary of Labor shall, by regulation, determine) arising out of the fact that the spouse, or a son, daughter, or parent of the employee is on covered active duty (or has been notified of an impending call or order to covered active duty) in the Armed Forces. In addition, FMLA section 102(a)(3) provides leave for FMLA purposes due to the need of an employee who is a spouse, son, daughter, parent, or next-of-kin of an eligible service member to care for such service member.

[625] These terms mean these types of leave within the meaning of FMLA section 102(d)(2).

[626] Pub. L. No. 116-127; Secs. 3131, 3132. The employer may not claim a credit under section 45S with respect to the qualified sick leave or family leave wages paid but may be able to take a credit under section 45S with respect to any additional wages paid, provided the requirements of section 45S are met with respect to the additional wages.

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

[628] Sec. 45S(i).

Effective Date

The proposal is effective upon date of enactment.

6. Clarification of treatment of DISC gains and distributions of certain foreign shareholders

Present Law

The U.S. tax system has had various provisions intended to ameliorate disadvantages that U.S. multinational enterprises may face in competing with entities based in jurisdictions that based their tax regimes on territorial principles to a greater extent than the United States did prior to 2018. By exempting foreign-source income to varying degrees, the tax systems of other countries arguably provide a competitive advantage for their exports (as well as other foreign-related business activities of their residents). The DISC and FSC regimes were designed to address that disparity. The FSC regime was later repealed and replaced by the extraterritorial income systems ("ETI") in 2000, with transition rules that allowed continued existence of certain FSCs.[629] Only a modified version of the DISC regime remains in effect, as described below.

Under the IC-DISC regime, certain domestic corporations are exempt from Federal corporate income tax on their export income, with partial deferral of tax for its shareholders. In general, the IC-DISC is not subject to corporate-level Federal income tax.[630] To qualify as an IC-DISC, a domestic corporation must have a valid election (to which all shareholders consent) to be taxed as a IC-DISC[631] and satisfy the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets; the corporation

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[629] Former secs. 921 through 927 (FSC); former secs. 941-943. See section 2, *The FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, Pub. L. No. 106-519, which provided that no new FSCs could be created, terminated inactive FSCs, but allowed an election to be treated as a domestic corporation under former section 943. With the repeal of the ETI provisions in 2004, further transition rules were provided for transactions in taxable years 2005 and 2006. Sec. 101(b)(2), *American Jobs Creation Act of 2004*, Pub. L. No. 108-357. Earlier efforts included the special rules and benefits for China Trade Corporations and Western Hemisphere Corporations under the Code of 1939, in addition to the partial deferral for DISCS under the Internal Revenue Code of 1954. Prior to being supplanted by FSCs, DISCs were eligible for more generous tax benefits. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 1066.

For an overview of the history of various special regimes and the trade disputes they engendered, see Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 81. (Fourth Ed. 2016). See also, *Joint Committee on Taxation, The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

[630] Sec. 991.

[631] See Form 4876-A, *Election to be Treated as an Interest-Charge DISC*.

must have no more than one class of stock; and the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year.[632]

While an election is in effect, it applies to each shareholder who owns stock in the corporation. Personal holding companies, corporations exempt from tax under section 501, regulated investment companies, insurance companies, and S corporations are ineligible to be treated as IC-DISCs.[633] An IC-DISC is not required to have its own employees, offices or equipment. It need only have a bank account and be maintained as a separate accounting entity.[634]

Shareholders are generally not required to pay tax on undistributed taxable income of the IC-DISC to the extent that the taxable income is attributable to no more than $10 million qualified export receipts annually. Instead, shareholders must pay an interest charge to account for the benefit of deferring the tax liability on undistributed IC-DISC income. The shareholders of a corporation that is not currently an IC-DISC but was in a previous taxable year and has previously-taxed income or accumulated IC-DISC income, are also required to pay interest on the deferral benefit. Gain on the sale or exchange of stock in such corporation is treated as a dividend.[635]

The deferral benefit is the excess of the amount of tax for which the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. The rate is the average of one-year constant maturity Treasury yields.[636]

Shareholders of an IC-DISC are subject to tax on actual distributions as well as certain items of DISC income that are treated as deemed distributions for the taxable year. Individual shareholders who receive distributions that are treated as dividends are entitled to the rate on qualified dividends, i.e., the rate applicable to net capital gains.[637] Corporations are not eligible for a dividends-received deduction on any distributions received by an IC-DISC.[638] Gains, dividends and other distributions (including deemed distributions) to foreign shareholders, whether corporate or nonresident aliens, are treated as income that is effectively connected with

[632] Secs. 992(a) and (b). If a corporation fails to satisfy either or both 95-percent tests, it may be deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. Sec. 992(c).

[633] Sec. 992(d).

[634] Treas. Reg. § 1.992-1(a)(7).

[635] Sec. 995(c)(1)(B).

[636] Sec. 995(f).

[637] Secs. 995(a) and (b); sec. 1(h)(11) provides a tax rate of 15 percent for individuals.

[638] Sec. 246(d).

a U.S. trade or business conducted through a permanent establishment and therefore derived from sources in the United States.[639]

Most IC-DISC deemed distributions[640] are comprised of interest on producer's loans (defined in section 993(d)); gains on the sale or exchange of property (other than qualified export property) previously acquired by the IC-DISC in a tax-free transaction; 50 percent of the taxable income of the IC-DISC attributable to military property; taxable income attributable to qualified export receipts that exceed $10,000,000;[641] and, if the shareholder is a C corporation, 1/17th of the taxable income during the year (after accounting for the items above, but before accounting for any actual distributions made).

The amount of deemed distributions cannot exceed the IC-DISC's earnings and profits for any given year, even if the IC-DISC has accumulated earnings and profits.[642] Since a shareholder does not actually receive a constructive dividend, the shareholder's basis in the IC-DISC is increased by the amount of the dividend.[643] When that portion of the IC-DISC's previously taxed income is actually distributed to the shareholder, this income is not taxed to the shareholder, and reduces the shareholder's basis in the IC-DISC. To the extent such a distribution exceeds the shareholder's basis, it is treated as gain on the sale or exchange of property.[644]

Any actual distribution is considered to be distributed first out of previously taxed income, then from accumulated tax deferred income, and then from all other earnings and profits.[645] Gain on the sale of IC-DISC stock is treated as a dividend to the extent of accumulated IC-DISC income.[646]

Description of Proposal

Foreign shareholders of DISCs and FSCs are deemed to have a permanent establishment in the United States from which any DISC or FSC gains or distributions are derived.

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639 Sec. 996(g).

640 The full list can be found in section 995(b)(1).

641 Sec. 995(b)(4). The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of $10 million. For purposes of this calculation, multiple IC-DISCs that are part of the same controlled group are treated as one corporation (which has the effect of aggregating their receipts).

642 Treas. Reg. § 1.995-2(b).

643 Sec. 996(e).

644 Sec. 996(e).

645 Sec. 996(a).

646 Sec. 995(c).

Effective Date

The proposal is applicable to gains and distributions after [December 31, 2021].

7. Access to self-employment income information for paid leave administration

Present Law

Confidentiality of returns and return information

Section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to such information except as provided in the Code. There are a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances.

For example, the Code provides for 22 specific exceptions to allow the disclosure of returns and return information to various persons or entities for a nontax administration purpose.[647]

Universal paid family and medical leave

Subtitle A of the proposal creates a universal paid family and medical leave benefit in a new title XXII of the Social Security Act. The paid leave benefit is administered by the Secretary and provides up to 12 weeks of paid family and medical leave per year for workers to address their own serious medical issue, the serious medical issue of a family member, the birth or adoption of a child, the death of a family member (up to 3 days for a typical worker employed 5 days per week), and for circumstances arising from a loved one's military deployment or serious injury.

The amount of the benefit is determined under a progressive benefit formula, designed to replace at least two-thirds of monthly earnings for most workers and a larger share of earnings for low-income workers. The benefit applies to employees and self-employed individuals. The determination of benefit amounts is based on wage or self-employment income data from the most recent eight calendar quarters. For employees, the Secretary shall utilize wage date from the National Directory of New Hires in making benefit determinations.

Description of Proposal

The proposal provides an exception to the general rule of confidentiality for disclosure of certain return information of self-employed individuals to carry out the paid family and medical leave benefit program. Under the provision, upon written request from the Secretary, officers and employees of the Department of the Treasury will have access to return information for a taxpayer whose self-employment income is relevant in determining eligibility for, or the correct amount of, a paid family and medical leave benefit under title XXII of the Social Security Act. Such information is limited to (i) taxpayer identity information of the taxpayer, (ii) self-

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[647] Sec. 6103(l)(1) through (l)(22).

employment income of the taxpayer,[648] and (iii) the taxable year to which the self-employment income relates. The information may be used solely for the purpose of administering the paid family and medical leave benefit program.

Effective Date

The proposal is effective upon date of enactment.

8. Temporary rule to allow certain S corporations to reorganize as partnerships without tax

Present Law

For Federal tax purposes, business income is taxed under rules relating to the form in which the business is conducted. The business may take the form of an entity or may be conducted as a sole proprietorship.[649] The principal business entities for Federal income tax purposes are C corporations,[650] partnerships, and S corporations. Partnerships and S corporations are often referred to as "passthrough entities" because their income is included in the gross income of the owners of the entities rather than in the income of the entities themselves.

Partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities not subject to tax at the entity level.[651] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[652] A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.[653] Losses not allowed as a result of that limitation generally are carried forward to the next year. A

[648] As defined in section 1402(b) for purposes of the taxes imposed by section 1401(b).

[649] A sole proprietorship is generally not treated as an entity separate from its owner. More complex or specialized arrangements involving, for example, affiliated corporations, tiered entities, special purpose entities, real estate investment trusts ("REITs"), regulated investment companies (mutual funds or "RICs") or foreign entities or investments are beyond the scope of this discussion.

[650] For a discussion of the taxation of C corporations, see Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2021*, (JCX-18-21), April 15, 2021, pp. 15-22, available at www.jct.gov.

[651] Sec. 701. Note, however, that certain publicly traded partnerships are treated as corporations. See sec. 7704.

[652] Sec. 702(a).

[653] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely-held corporations) and may not be important to individual partners who have partner-level passive income from other investments.

partner's adjusted basis in the partnership interest generally equals the sum of (1) the partner's capital contributions to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any partnership distributions to the partner.[654] Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.[655]

In contrast with a corporation and its shareholders (for which the Code prescribes rules that generally do not allow different treatment of similarly situated shareholders), partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations meet a test for substantial economic effect or are made in accordance with the partners' interests in the partnership.[656] In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.[657]

S corporations

For Federal income tax purposes, an S corporation[658] generally is not subject to tax at the corporate level.[659] In computing their income tax liabilities, S corporation shareholders take into account their pro rata shares of items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation (based on the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to such shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year. A shareholder's adjusted basis in the S corporation stock generally equals the sum of (1) the shareholder's capital contributions to the S corporation and (2) the shareholder's pro rata share of S corporation income, less (1) the shareholder's pro rata share of losses allowed as a deduction

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[654] Sec. 705.

[655] Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income).

[656] Sec. 704(b).

[657] Treas. Reg. sec. 1.704-1(b)(2).

[658] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

[659] Secs. 1363 and 1366.

and certain nondeductible expenditures, and (2) any S corporation distributions to the shareholder.[660]

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.[661] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted to be shareholders of an S corporation. A corporation may elect S corporation status only with the consent of all of its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[662] Measured by assets or profits, for example, businesses organized as S corporations may be as large as those organized as C corporations or partnerships. Certain corporations may not elect S corporation status, including financial institutions using the reserve method of accounting for bad debts and insurance companies subject to tax under subchapter L.[663]

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation.

Certain differences between the tax treatment of partnerships and S corporations

In the case of the death of an owner (*i.e.*, a partner or shareholder), partnerships and S corporations provide differing tax treatment. Specifically, upon the death of an individual S corporation shareholder or partner, the basis of the deceased shareholder's S corporation stock or the deceased partner's partnership interest in the hands of the heirs is its fair market value at the time of the shareholder's or partner's death (or the alternate valuation date).[664] In the case of a partnership, but not in the case of an S corporation, the basis of the partnership's assets is equal to the fair market value of the assets at the time of the deceased partner's death (or alternate valuation date), if the partnership has an election in effect under section 754 to adjust the basis of partnership assets.

Differing rules apply to a business seeking to convert to partnership or to S corporation status. For example, a C corporation may convert to an S corporation, but not a partnership, without immediate recognition of gain at either the corporate or the shareholder level. The conversion of a C corporation to a partnership is treated as a liquidation of the C corporation, and

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[660] Sec. 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. Sec. 1367(b)(2).

[661] Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

[662] Sec. 1362.

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

[664] Sec. 1014.

generally requires the corporation to recognize and pay tax on the built-in gain on its assets.[665] However, the conversion of a C corporation to an S corporation (achieved through electing S corporation status) is not treated as a liquidation of the C corporation.[666] Thus, if a C corporation can satisfy the limits on the number and types of shareholders, the single class of stock requirement, and other requirements for S corporation status, a conversion of a C corporation to an S corporation is not taxable, and all post-conversion income and appreciation of assets in the entity are subject only to shareholder-level tax.[667]

Similarly, the termination of a subchapter S election results in the conversion of the S corporation to a C corporation generally on a tax-free basis, whether the termination is by a shareholder revocation of the election or because the corporation no longer satisfies the definition of a small business corporation.[668] However, the conversion of an S corporation into a partnership is generally treated as a taxable liquidation of the S corporation.[669]

Description of Proposal

The proposal temporarily allows an eligible S corporation to elect to reorganize as a partnership without the application of the otherwise applicable Federal income tax to the S corporation or its shareholders. Specifically, the proposal treats a qualified liquidation of an eligible S corporation as a complete liquidation under section 332(b), and the transferee domestic partnership as (i) if it were a corporation which is an 80-percent distributee (within the meaning of section 337(c)) and (ii) a successor corporation of the eligible S corporation for purposes of section 1362(g).

An eligible S corporation is (i) any corporation (including any predecessor) that was an S corporation on May 13, 1996, and at all times thereafter through the date on which the qualified liquidation is completed, and (ii) that elects the application of the proposal. A qualified liquidation is one or more transactions occurring within the two-year period beginning on December 31, 2021, which constitute the complete liquidation of the eligible S corporation, and the transfer of substantially all of the assets and liabilities of such S corporation to a domestic partnership.

[665] See secs. 336-338 (providing some exceptions to this treatment).

[666] Certain built-in gain of a C corporation that elects S corporation status remains subject to C corporation tax if recognized within five years after the conversion. See sec. 1374.

[667] For a chart summarizing tax differences among C corporations, partnerships, S corporations, and sole proprietorships, see Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, pp. 11-16, available at www.jct.gov.

[668] See secs. 1361 and 1362.

[669] See secs. 331 and 336.

An election must be made by the eligible S corporation in such manner as the Secretary may require and not later than the due date for filing the return of tax for the taxable year in which such liquidation is completed.

The Secretary is directed to issue regulations or other guidance as may be necessary or appropriate to carry out the proposal.

Consequently, the proposal allows eligible S corporations to reorganize as partnerships without tax on built-in gain on the S corporation's assets. The proposal also allows S corporations that would have continued as S corporations under present law to reorganize as partnerships, thereby allowing partners who could not be S corporation shareholders under present law (such as nonresident alien or foreign individuals, certain tax-exempt organizations that are not allowed as S corporation shareholders, other partnerships or corporations, and more than one hundred partners). In addition, after reorganizing as a partnership, the former S corporation can make non-pro-rata allocations of income, gain, loss, deduction, and credits among the partners that are not permitted under the S corporation rules.

Effective Date

The proposal is effective for transactions occurring on or after December 31, 2021, and before January 1, 2024.

9. Treatment of certain qualified sound recording productions

Present Law

Expensing of certain qualified film, television, and live theatrical productions

Under section 181, a taxpayer may elect[670] to deduct up to $15 million of the aggregate production costs of any qualified film, television or live theatrical production, commencing prior to January 1, 2026,[671] 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.[672] The dollar limitation is increased to $20 million if a significant amount of

[670] See Treas. Reg. sec. 1.181-2 for rules on making (and revoking) an election under section 181.

[671] For purposes of determining whether a production is eligible for section 181 expensing, a qualified film or television production is treated as commencing on the first date of principal photography. The date on which a qualified live theatrical production commences is the date of the first public performance of such production for a paying audience.

[672] Sec. 181(a)(2)(A). See Treas. Reg. sec. 1.181-1 for rules on determining eligible production costs. Eligible production costs under section 181 include participations and residuals paid or incurred. Treas. Reg. sec. 1.181-1(a)(3)(i). The special rule in section 167(g)(7) that allows taxpayers using the income forecast method of depreciation to include participations and residuals that have not met the economic performance requirements in the adjusted basis of the property for the taxable year the property is placed in service does not apply for purposes of section 181. Treas. Reg. sec. 1.181-1(a)(8). Thus, under section 181, a taxpayer may only include participations and residuals actually paid or incurred in eligible production costs. Further, production costs do not include the cost of obtaining a production after its initial release or broadcast. See Treas. Reg. sec. 1.181-1(a)(3). For this purpose,

the production costs are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[673]

A section 181 election may only be made by an owner of the production.[674] An owner of a production is any person that is required under section 263A to capitalize the costs of producing the production into the cost basis of the production, or that would be required to do so if section 263A applied to that person.[675] In addition, the aggregate production costs of a qualified production that is co-produced include all production costs, regardless of funding source, in determining if the applicable dollar limit is exceeded. Thus, the term "aggregate production costs" means all production costs paid or incurred by any person, whether paid or incurred directly by an owner or indirectly on behalf of an owner.[676] 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 the income forecast method, or section 168(k) if eligible, as discussed below).[677]

A qualified film, television, or live theatrical production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format), television program, or live staged play if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[678] Solely for purposes of this rule, the term

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"initial release or broadcast" means the first commercial exhibition or broadcast of a production to an audience. Treas. Reg. sec. 1.181-1(a)(7). Thus, *e.g.*, a taxpayer may not expense the purchase of an existing film library under section 181. See T.D. 9551, 76 Fed. Reg. 64816, October 19, 2011.

[673] Sec. 181(a)(2)(B).

[674] Treas. Reg. sec. 1.181-1(a).

[675] Treas. Reg. sec. 1.181-1(a)(2)(i).

[676] Treas. Reg. sec. 1.181-1(a)(4). See Treas. Reg. sec. 1.181-2(c)(3) for the information required to be provided to the Internal Revenue Service when more than one person will claim deductions under section 181 for a production (to ensure that the applicable deduction limitation is not exceeded).

[677] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS-1-09), March 2009, p. 448; and Treas. Reg. sec. 1.181-1(c)(2). A production is generally considered to be placed in service at the time of initial release, broadcast, or live staged performance (*i.e.*, at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience). See, *e.g.*, Rev. Rul. 79-285, 1979-2 C.B. 91; and Priv. Ltr. Rul. 9010011, March 9, 1990. See also, Treas. Reg. sec. 1.181-1(a)(7). However, a production generally may not be considered to be placed in service if it is only exhibited, broadcasted or performed for a limited test audience in advance of the commercial exhibition, broadcast, or performance to general audiences. See Priv. Ltr. Rul. 9010011 and Treas. Reg. sec. 1.181-1(a)(7).

[678] Sec. 181(d)(3)(A).

"compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)).[679]

Each episode of a television series is treated as a separate production, and only the first 44 episodes of a particular series qualify under the provision.[680] Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the U.S. Code.[681]

A qualified live theatrical production is defined as a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a commercial entity in any venue which has an audience capacity of not more than 3,000, or a series of venues the majority of which have an audience capacity of not more than 3,000.[682] In addition, qualified live theatrical productions include any live staged production which is produced or presented by a taxable entity no more than 10 weeks annually in any venue which has an audience capacity of not more than 6,500.[683] In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production. Similar to the exclusion for sexually explicit productions from the definition of qualified film or television productions, qualified live theatrical productions do not include productions that include or consist of any performance of conduct described in section 2257(h)(1) of title 18 of the U.S. Code.[684]

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.[685] Thus, the deduction under section 181 may be subject to recapture as ordinary income in the taxable year in which (i) the taxpayer revokes a section 181 election, (ii) the production fails to meet the requirements of section 181, or (iii) the taxpayer sells or otherwise disposes of the production.[686]

[679] Sec. 181(d)(3)(B). Participations and residuals are defined as, with respect to any property, costs the amount of which by contract varies with the amount of income earned in connection with such property. See also Treas. Reg. sec. 1.181-3(c).

[680] Sec. 181(d)(2)(B).

[681] Sec. 181(d)(2)(C).

[682] Sec. 181(e)(2)(A).

[683] Sec. 181(e)(2)(D).

[684] Sec. 181(e)(2)(E).

[685] Sec. 1245(a)(2)(C). For a discussion of the recapture rules applicable to depreciation and amortization deductions, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021, pp. 14-17. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[686] See Treas. Reg. sec. 1.181-4.

Depreciation of certain intangible property

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.[687] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[688] 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 placed in service convention.[689]

Films, videos, and sound recordings

MACRS generally does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years.[690] Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions.[691] The cost recovery of such property is determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property if it is used in a trade or business or held for the production of income. In addition, the costs of motion picture films, video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation once the property is placed in service.[692]

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[687] 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 tax benefits such as 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.

[688] 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).

[689] Sec. 168.

[690] Sec. 168(f)(1), (3) and (4).

[691] Under section 197, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years. No other depreciation or amortization deduction (such as bonus depreciation under section 168(k)) is allowable with respect to any section 197 intangible. Section 197 does not apply to certain intangible property, including certain property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. See sec. 197(c)(2) and (e)(4)(A).

[692] Sec. 167(g)(6).

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property is placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property is placed in service may be taken into account as depreciation in that year.[693]

Additional first-year depreciation deduction for certain productions

Under section 168(k), qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft), as well as specified plants planted or grafted after September 27, 2017, and before January 1, 2023, is eligible for an additional first-year depreciation deduction equal to 100 percent of the adjusted basis of the property. The 100-percent allowance is phased down by 20 percent per calendar year for qualified 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), as well as specified plants planted or grafted after December 31, 2022. This additional first-year depreciation is commonly referred to as "bonus depreciation."

Qualified property eligible for bonus depreciation under section 168(k) includes qualified film, television, and live theatrical productions placed in service after September 27, 2017, and before January 1, 2027, for which a deduction otherwise would have been allowable under section 181, without regard to the dollar limitation or termination of such section.[694] A qualified production is considered to be placed in service, and thus eligible for bonus depreciation, at the time of initial release, broadcast, or live staged performance (*i.e.*, at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).[695]

Description of Proposal

The proposal expands the special expensing rules for qualified film, television, and live theatrical productions under section 181 to include qualified sound recording production costs of up to $150,000 per taxable year. A qualified sound recording production is defined as a sound

[693] Sec. 167(g)(1). In general, the adjusted basis of property that may be taken into account under the income forecast method only includes amounts that have been incurred under the economic performance requirements of section 461(h). An exception to this rule applies to participations and residuals. Specifically, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service (even if economic performance has not yet occurred) if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service. For this purpose, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. See sec. 167(g)(7).

[694] See sec. 168(k)(2)(A); Treas. Reg. sec. 1.168(k)(2)(b).

[695] See Treas. Reg. sec. 1.168(k)-2(b)(4)(iii).

recording (as defined in section 101 of title 17 of the U.S. Code) produced and recorded in the United States.

The proposal also expands the definition of qualified property eligible for bonus depreciation to include qualified sound recording productions (*i.e.*, for the production costs in excess of $150,000 once the production is placed in service). For purposes of the proposal, a qualified sound recording production is considered to be placed in service at the time of initial release or broadcast.

Effective Date

The proposal applies to productions commencing in taxable years ending after the date of enactment.

10. Payment to certain individuals who dye fuel

Present Law

In general, under section 4081, tax is imposed upon the removal of taxable fuel (including diesel fuel and kerosene) from a terminal. Taxable fuel transferred in bulk by pipeline or vessel to registered terminals is exempt from the tax imposed by section 4081. The Code provides exemptions from section 4081 taxes for diesel fuel and kerosene destined for nontaxable uses, provided that fuel is indelibly dyed in accordance with Treasury regulations.

Under section 4081(e), if tax is paid and reported to the government on more than one taxable event for a taxable fuel under section 4081, the person paying the "second tax" on such fuel may claim a refund (without interest) of that second tax if certain conditions and reporting requirements are met. As an example, if fuel is removed from a terminal, taxed, and then transported by truck to a second terminal, the tax imposed upon removal from the second terminal is the second taxable event. The person who paid the second tax may make a claim a refund under section 4081(e). However, if the fuel is dyed at removal from the second terminal, there is no second tax paid on the fuel and refund relief is not available under section 4081(e) for the dyed fuel.

Description of Proposal

The proposal creates a new refund mechanism that would allow for refunds, without interest, to a taxpayer who removes from a terminal "eligible indelibly dyed diesel fuel or kerosene" for nontaxable use, and establishes to the satisfaction of the Secretary that tax for such fuel under section 4081 has already been paid. The term "eligible indelibly dyed diesel fuel or kerosene" means diesel fuel or kerosene with respect to which a tax under section 4081 was previously paid (and not credited or refunded) and which is exempt from taxation under section 4082(a) (relating to exemptions for diesel fuel and kerosene destined for a nontaxable use).

Effective Date

The proposal applies to previously taxed, eligible indelibly dyed diesel fuel or kerosene removed on or after the date that is 180 days after the date of enactment.

11. Extension of credit for portion of employer social security taxes paid with respect to employee tips to beauty service establishments

Present Law

Federal employment taxes

Federal employment taxes are imposed on wages paid to employees with respect to employment and include taxes imposed under the Federal Insurance Contributions Act ("FICA"), the Federal Unemployment Tax Act ("FUTA"), and Federal income tax.[696] In addition, Tier 1 of the Railroad Retirement Tax Act ("RRTA") imposes a tax on compensation paid to railroad employees and representatives.[697]

FICA taxes are comprised of two components: the Old-Age, Survivors, and Disability Insurance ("OASDI") and Hospital Insurance ("Medicare"). With respect to OASDI taxes, the applicable rate is 12.4 percent with half of such rate (6.2 percent) imposed on the employee and the remainder (6.2 percent) imposed on the employer.[698] The tax is assessed on covered wages up to the OASDI wage base ($142,800 in 2021). Generally, the OASDI wage base rises based on increases in the national average wage index.[699] With respect to Medicare taxes,[700] the applicable rate is 2.9 percent with half of such rate (1.45 percent) imposed on the employee and the remainder (1.45 percent) imposed on the employer.[701]

The tax is assessed on covered wages, which is defined for FICA tax purposes as all remuneration for "employment," including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.[702] The name given to the remuneration for employment is immaterial. FICA wages includes salaries, vacation allowances, bonuses, deferred compensation, commissions, and fringe benefits. The term "employment" is generally defined for FICA tax purposes as any service, of whatever nature, performed by an employee for the person employing him or her, with certain specific exceptions.

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[696] Secs. 3101, 3111, 3301, and 3401.

[697] Sec. 3221.

[698] Sec. 3101.

[699] Sec. 230 of the Social Security Act (42 U.S.C. sec. 430).

[700] The Hospital Insurance tax includes two components: Medicare tax and Additional Medicare tax. Additional Medicare taxes are imposed on wages in excess of certain thresholds and are only imposed on the employee. Sec. 3101(b). There is no employer match for Additional Medicare tax. For purposes of this explanation, when referencing Medicare taxes, the term does not include Additional Medicare tax.

[701] Sec. 3101(b); 3111(b).

[702] Sec. 3121(a).

Employer credit for employee tips

Employee tip income is treated as wages for FICA tax purposes,[703] and tips received by an employee in the course of his or her employment are remuneration for employment and deemed to have been paid by the employer for FICA tax purposes.[704] Employees are required to report to the employer tips received by the employee.[705]

Employers that operate food and beverage establishments are eligible for a nonrefundable general business tax credit[706] equal to an employer's FICA taxes paid on tips in excess of those treated as wages for purposes of meeting the minimum wage requirements of the Fair Labor Standards Act ("FLSA").[707] The credit applies only with respect to FICA taxes paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary. The credit is available whether or not the employee reports the tips on which the employer FICA taxes were paid. No deduction is allowed for any amount taken into account in determining the tip credit. A taxpayer may elect not to have the credit apply for a taxable year.

Description of Proposal

The proposal extends the tip credit to beauty service businesses. Under the proposal, tips received from customers or clients in connection with the following services are eligible for the credit: (1) providing, delivering or servicing of food and beverages for consumption, if the tipping of employees delivering or serving food or beverages by customers is customary; and (2) providing beauty services to a customer or client if the tipping of employees providing such services is customary. Beauty service is defined as barbering and hair care, nail care, esthetics, and body and spa treatments.

The amount of the tip credit for an employer providing beauty services is the FICA taxes paid by the employer with respect to tip income deemed to have been paid by the employer to the

[703] Section 3121(a)(12)(A) provides that the definition of wages does not include tips paid in any medium other than cash. Section 3121(a)(12)(B) excludes from the definition of wages cash tips received by an employee in any calendar month in the course of employment unless the amount of the cash tips is $20 or more.

[704] Sec. 3121(q).

[705] Sec. 6053(a).

[706] Sec. 38.

[707] Sec. 45B. The tip credit applies to the employer's share of both OASDI and Medicare taxes on tip income in excess of the required minimum wage, which for these purposes is $2.13 per hour. Sec. 45B(b)(1).

employee in excess of the minimum wage rate applicable to such individual under section 6(a)(1) of the FLSA, determined without regard to section 3(m) of such Act.[708]

Effective Date

The amendments made by this proposal shall apply to taxable years beginning after December 31, 2021.

12. Enhancement of work opportunity credit during COVID-19 recovery period

Present Law

In general

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

Targeted groups eligible for the credit

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

(1) Families receiving TANF

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

(2) Qualified veteran

A qualified veteran is a veteran who is certified by the designated local agency as belonging to one of five categories: (1) a member of a family eligible to receive assistance under a supplemental nutritional assistance program (for at least a three-month period during the year prior to the hiring date); (2) entitled to compensation for a service-connected disability and hired within one year of discharge; (3) entitled to compensation for a service-connected disability and unemployed for an aggregate of at least six months during the one-year period ending on the

[708] Secs. 45S(b)(1)(A); 3121(q). The amount of the tip credit for food and beverage establishments remains unchanged in the amount of the employer's FICA taxes on employee tip income in excess of the FLSA minimum wage of $2.13.

hiring date; (4) unemployed for at least four weeks but less than six months (whether or not consecutive) during the one-year period ending on the date of hiring; or (5) unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring.

A veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

<u>(3) Qualified ex-felon</u>

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

<u>(4) Designated community resident</u>

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

<u>(5) Vocational rehabilitation referral</u>

A vocational rehabilitation referral is an individual who is certified by the designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing vocational rehabilitation services: (1) under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; (2) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code; or (3) under an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification is provided by the designated local agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified summer youth employee

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

(7) Qualified supplemental nutrition assistance program benefits recipient

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

(8) Qualified SSI recipient

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

(9) Long-term family assistance recipient

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

(10) Long-term unemployment recipient

A qualified long-term unemployment recipient is an individual certified by the designated local agency as being in a period of unemployment which: (1) is 27 consecutive weeks or more; and (2) includes a period in which the individual was receiving unemployment compensation under State or Federal law.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.[709]

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

Calculation of the credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum per-employee credit is $2,400 (40 percent of the first $6,000 of qualified first-year wages).

The general $6,000 limitation on qualified first-year wages is different for certain targeted groups: (1) qualified summer youth employees; (2) qualified veterans who are entitled to compensation for a service-connected disability, and who are hired within one year of discharge; (3) qualified veterans who are entitled to compensation for a service-connected disability, and who have been unemployed for an aggregate of at least six months during the one-year period ending on the hiring date; (4) qualified veterans unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring; and (5) long-term family assistance recipients. The maximum per-employee credit (and limitation on qualified wages) for a member of each of the first four of these groups is, respectively: (1) $1,200 (40 percent of the first $3,000 of qualified first-year wages); (2) $4,800 (40 percent of the first $12,000 of qualified first-year wages); (3) $9,600 (40 percent of the first $24,000 of qualified first-year wages); and (4) $5,600 (40 percent of the first $14,000 of qualified first-year wages).

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of $10,000 for qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of $10,000) attributable to service rendered by a

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[709] Sec. 280C(a).

member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $9,000 (40 percent of the first $10,000 of qualified first-year wages plus 50 percent of the first $10,000 of qualified second-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

Certification rules

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

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

Minimum employment period

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

Qualified tax-exempt organizations employing qualified veterans

The credit is not available to qualified tax-exempt organizations other than those employing qualified veterans. If a qualified tax-exempt organization employs a qualified veteran (as described above) a tax credit against the FICA taxes of the organization is allowed for the wages of the qualified veteran which are paid for the veteran's services in furtherance of the activities related to the function or purpose constituting the basis of the organization's exemption under section 501.[710]

The credit available to a tax-exempt employer for qualified wages paid to a qualified veteran equals 26 percent (16.25 percent for employment of 400 hours or less) of qualified first-year wages. The amount of qualified first-year wages eligible for the credit is the same as those

[710] Sec. 3111(e).

for non-tax-exempt employers (*i.e.*, $6,000, $12,000, $14,000 or $24,000, depending on the category of qualified veteran).

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

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

Treatment of possessions

The "VOW to Hire Heroes Act of 2011" (the "VOW Act")[711] provides a reimbursement mechanism for the U.S. possessions (American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, and the United States Virgin Islands). The Secretary pays to each mirror Code possession (Guam, the Commonwealth of the Northern Mariana Islands, and the United States Virgin Islands) an amount equal to the loss to that possession as a result of the VOW Act changes to the qualified veterans rules.[712] Similarly, the Secretary pays to each non-mirror Code possession (American Samoa and the Commonwealth of Puerto Rico) the amount that the Secretary estimates as being equal to the loss to that possession that would have occurred as a result of the VOW Act changes if a mirror Code tax system had been in effect in that possession. The Secretary makes this payment to a non-mirror Code possession only if that possession establishes to the satisfaction of the Secretary that the possession has implemented (or, at the discretion of the Secretary, will implement) an income tax benefit that is substantially equivalent to the qualified veterans credit allowed under the VOW Act modifications.

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

Other significant rules

The work opportunity tax credit generally is not allowed for wages paid to individuals who were previously employed by the employer (the "rehire prohibition"). The credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than 50-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax

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[711] Pub. L. No. 112-56.

[712] Prior to enactment of the VOW Act, there were two categories of qualified veterans to whom wages paid by an employer were eligible for the credit. Employers that hired veterans who were eligible to receive assistance under a supplemental nutritional assistance program were entitled to a maximum credit of 40 percent of $6,000 of qualified first-year wages paid to such individual. Employers that hired veterans who were entitled to compensation for a service-connected disability were entitled to a maximum wage credit of 40 percent of $12,000 of qualified first-year wages paid to such individual. The VOW Act expanded the work opportunity tax credit with respect to qualified veterans resulting in the present-law treatment of qualified veterans described above.

credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit.

Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after December 31, 2025.

Description of Proposal

Generally, the proposal temporarily increases the credit amount to 50 percent of qualified first-year wages (up to a maximum of $10,000 of qualified first-year wages) and 50 percent of qualified second-year wages (up to a maximum of $10,000 of qualified second-year wages) for individuals who (1) are not qualified summer youth employees and (2) are hired after the date of enactment and before January 1, 2023 ("qualified hires"). Therefore, the maximum credit per employee is generally $10,000 (50 percent of the first $10,000 of qualified first-year wages plus 50 percent of the first $10,000 of qualified second-year wages). Qualified second-year wages are qualified wages which are attributable to service during the one-year period beginning on the day after the last day of the first one-year period.

For long-term family assistance recipients, the maximum per-employee credit (and limitation on qualified first-year wages) temporarily increases to $5,000 for the first year of employment (50 percent of the first $10,000 of qualified first-year wages) and remains at $5,000 for the second year of employment (50 percent of the first $10,000 of qualified second-year wages).

The $10,000 annual limitation on qualified first-year wages and qualified second-year wages does not apply to certain targeted groups: (1) qualified veterans who are entitled to compensation for a service-connected disability, and who are hired within one year of discharge; (2) qualified veterans who are entitled to compensation for a service-connected disability, and who have been unemployed for an aggregate of at least six months during the one-year period ending on the hiring date; (3) qualified veterans unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring; and (4) qualified summer youth employees. The maximum per-employee credit (and limitation on qualified wages) for a member of one of the first three groups is, respectively: (1) $12,000 (50 percent of the first $12,000 of qualified first-year wages plus 50 percent of the first $12,000 of second-year wages); (2) $24,000 (50 percent of the first $24,000 of qualified first-year wages plus 50 percent of the first $24,000 of qualified second-year wages; and (3) $14,000 (50 percent of the first $14,000 of qualified first-year wages plus 50 percent of the first $14,000 of qualified second-year wages).

The proposal does not apply to qualified summer youth employees. Therefore, the maximum per-employee credit (and limitation on qualified first-year wages) for such individuals remains at $1,200 (40 percent of the first $3,000 of qualified first-year wages).

The proposal temporarily waives the rehire prohibition for qualified hires. The proposal also requires the Secretary to issue such regulations as appropriate to ensure a reasonable application of the waiver, including prohibiting attempts to claim the benefit through the termination and rehiring of an employee.

Effective Date

The proposal applies to taxable years ending after the date of enactment.

13. Allowance of deduction for certain expenses of the trade or business of being an employee

Present Law

Under the Code, gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute.[713] An individual's AGI is determined by subtracting certain "above-the-line" deductions from gross income, including trade or business expenses, losses from the sale or exchange of property, contributions to a qualified retirement plan by a self-employed individual, contributions to certain IRAs, certain moving expenses for members of the Armed Forces, and certain education-related expenses.[714]

To determine taxable income, an individual reduces adjusted gross income ("AGI") by either the applicable standard deduction or applicable itemized deductions,[715] and by the deduction for qualified business income.[716] The amounts of the standard deductions are indexed annually for inflation. The deductions that may be itemized in lieu of claiming the standard deduction include personal State and local income, property, and sales taxes (up to $10,000 annually ($5,000 for married taxpayers filing separately)), home mortgage interest (on mortgages up to certain specified dollar amounts), charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), and casualty and theft losses attributable to Federally declared disasters (in excess of 10 percent of AGI and in excess of $100 per loss). However, unreimbursed employee business expenses, such as dues for membership in work-related organizations or labor unions, are miscellaneous itemized deductions. Such deductions are currently suspended until taxable years beginning after December 31, 2025, and deductible only to the extent that miscellaneous itemized deductions in aggregate exceed two percent of AGI.[717]

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[713] Sec. 61.

[714] Sec. 62. In addition, alimony payments are generally deductible by the payor spouse for divorce and separation instruments executed before January 1, 2019.

[715] Sec. 63(a) and (b). The basic standard deduction varies depending on a taxpayer's filing status. For 2020, the amount of the standard deduction is $12,400 for a single individual and for a married individual filing separately, $18,650 for a head of household, and $24,800 for married taxpayers filing jointly and for a surviving spouse. An additional standard deduction is allowed with respect to any individual who is elderly (*i.e.*, above age 64) and/or blind.

[716] Secs. 63(b)(3), (d)(3), and 199A.

[717] Secs. 67(a) and (g).

Description of Proposal

In determining adjusted gross income, a taxpayer whose trade or business is the performance of services as an employee may deduct up to $250 paid as membership dues to a labor organization within the meaning of section 501(c)(5), provided that the employee remained a member of the organization through the end of the year.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2021.

14. Cover over of certain distilled spirits taxes

Present Law

Generally, distilled spirits are taxed at a rate of $13.50 per proof gallon.[718] Liability for the excise tax on distilled spirits arises when the distilled spirits are produced or imported but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced, or customs custody. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn from a distillery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.

There is a reduced tax rate schedule for distilled spirits based on the annual quantity (1) distilled or processed and removed for consumption or sale, or (2) imported into the United States. The rate of tax is lowered to $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits produced, $13.34 on the next 22,130,000 proof gallons, and $13.50 for amounts thereafter.

For purposes of the excise tax on distilled spirits, the territories of Puerto Rico and the U.S. Virgin Islands are not considered part of the United States.[719] Additionally, distilled spirits brought into the United States from these territories are not considered imports for purposes of the excise tax.[720] Thus, distilled spirits produced in these territories, whether or not brought into the United States, are not subject to tax under section 5001. However, section 7652(a) imposes an equalization tax equal to the tax imposed in the United States upon like articles of merchandise of domestic manufacture, including distilled spirits, produced in Puerto Rico and brought into the United States, and section 7652(b) imposes an equalization tax equal to the tax

[718] Secs. 5001, 5006, 5043, and 5054.

[719] Sec. 7701(a)(9).

[720] See 19 C.F.R. sec. 7.2 and 19 C.F.R. sec. 101.1.

imposed in the United States upon like articles of merchandise of domestic manufacture, including distilled spirits, produced in the U.S. Virgin Islands and brought into the United States.

The revenue from the equalization tax on rum produced in Puerto Rico and brought into the United States is transferred ("covered over") to the Treasury of Puerto Rico.[721] The revenue from the equalization tax on rum produced in the U.S. Virgin Islands and brought into the United States is covered over to the Treasury of the U.S. Virgin Islands.[722] In addition, the revenues from the excise tax imposed on rum imported into the United States (less certain administrative costs) are covered over to the Treasury of Puerto Rico and the Treasury of the U.S. Virgin Islands.[723] The revenues are apportioned between the two treasuries according to a formula determined by the Secretary.[724]

For purposes of both the cover over of the equalization tax on rum and the cover over of the tax imposed on rum imported into the United States, the amount covered over is limited to the lesser of the tax imposed or $10.50 per proof gallon. The $10.50 per proof gallon limitation is increased to $13.25 per proof gallon during the period from July 1, 1999, through December 31, 2021.[725]

With respect to both the cover over of the equalization tax on rum and the cover over of the tax imposed on rum imported into the United States, amounts covered over to Puerto Rico and the Virgin Islands are determined without regard to reduced rates or refunds in lieu of reduced rates. Refunds in lieu of reduced rates are not treated as refunds for purposes of determining the amounts of cover over.

Description of Proposal

The proposal repeals the limitation on cover over of taxes on rum to Puerto Rico and the Virgin Islands.

With respect to taxes collected on rum transported to the United States that are covered into the Treasury of Puerto Rico at a rate equal to or greater than $10.50 per proof gallon, the

[721] Sec. 7652(a)(3). For purposes of this provision, only distilled spirits for which at least 92 percent of the alcohol content is attributable to rum are eligible for cover over of equalization taxes. See sec. 7652(c).

[722] Sec. 7652(b)(3). For purposes of this provision, only distilled spirits for which at least 92 percent of the alcohol content is attributable to rum are eligible for cover over of equalization taxes. See sec. 7652(c).

[723] Sec. 7652(e)(1). For purposes of this provision the term "rum" means any article classified under subheading 2208.40.00 of the Harmonized Tariff Schedule of the United States (19 U.S.C. 1202). Sec. 7652(e)(4).

[724] Sec. 7652(e)(2).

[725] Sec. 7652(f)(1).

proposal requires Puerto Rico to transfer to the Puerto Rico Conservation Trust Fund[726] an amount per proof gallon of at least one-sixth of the difference between $10.50 and the rate (not to exceed $13.25) at which such taxes are covered into the Treasury of Puerto Rico. This requirement does not modify or impair payment priorities established under Puerto Rico law in effect on May 21, 2021.

Effective Date

The proposal generally applies to distilled spirits brought into the United States after December 31, 2021.

15. Delay in requirement to amortize research and experimental expenditures

Present Law

Public Law 115-97[727] modified section 174 for amounts paid or incurred in taxable years beginning after December 31, 2021 (with conforming changes made to sections 41 and 280C). 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.[728] However, with respect to taxable years beginning before January 1, 2022, taxpayers may elect to deduct currently the amount of certain reasonable research or experimental expenditures paid or incurred in connection with a trade or business.[729] Taxpayers may elect to forgo a current deduction, 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.[730] Taxpayers, alternatively, may elect to amortize their research or experimental

[726] The Puerto Rico Conservation Trust Fund is the fund established pursuant to a Memorandum of Understanding between the United States Department of the Interior and the Commonwealth of Puerto Rico, dated December 24, 1968.

[727] December 22, 2017.

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

[729] Secs. 174(a) and (e).

[730] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimental expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning its trade or business, a taxpayer may choose to defer the deduction and amortize its section 174 costs beginning with the

expenditures over a period of 10 years.[731] Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a)[732] or section 263A.[733] In addition, section 174 deductions are generally reduced by the amount of the taxpayer's research credit under section 41.[734]

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[735] 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.[736] 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.[737] 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. 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).[738] In addition, under administrative guidance,

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month in which the taxpayer first realizes benefits from the expenditures (*i.e.*, the month in which its active trade or business begins).

[731] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the AMT adjustment for research expenditures set forth in section 56(b)(2). Note that the corporate AMT was repealed for taxable years beginning after December 31, 2017. See Pub. L. No. 115-97, sec. 2001, December 22, 2017. Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimental expenditures.

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

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

[734] Sec. 280C(c). Taxpayers may alternatively 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.

[735] 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 eligible for section 174 treatment.

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

[737] *Ibid.*

[738] 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).

the costs of developing computer software have been accorded treatment similar to research and experimental expenditures.[739]

Research or experimental expenditures under section 174 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 literary, historical, or similar projects.[740] 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.[741]

Generally, no current 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.[742] In addition, no current 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 mineral, including oil and gas.[743]

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

With respect to taxable years beginning after December 31, 2021, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. Specified research or experimental expenditures that are attributable to research that is conducted outside of the United States[744] are required to be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

Specified research or experimental expenditures do not include expenditures for the acquisition or improvement of land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of

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

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

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

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

[743] 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).

[744] For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

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

The application of this rule is treated as a change in the taxpayer's method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. This rule is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021 (hence there is no adjustment under section 481(a) for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022).

If a taxpayer's research credit under section 41 (discussed more below) for a taxable year beginning after 2021 exceeds the amount allowed as an amortization deduction under section 174 for such taxable year, the amount chargeable to capital account under section 174 for such taxable year must be reduced by that excess amount. A taxpayer may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing its section 174 expenditures for the taxable year. If such an election is made, the research credit is reduced by an amount equal to that credit multiplied by the highest corporate tax rate.

Description of Proposal

The proposal delays the effective date for the modifications made to section 174 by Public Law 115-97 for four taxable years, such that they will apply to amounts paid or incurred in taxable years beginning after December 31, 2025.

Effective Date

The proposal is effective on the date of enactment.

16. Payroll credit for compensation of local news journalists

Present Law

Federal employment taxes

Federal employment taxes are imposed on wages paid to employees with respect to employment and include taxes imposed under the Federal Insurance Contributions Act ("FICA"), the Federal Unemployment Tax Act ("FUTA"), and Federal income tax.[745] In addition, Tier 1 of

[745] Secs. 3101, 3111, 3301, and 3401.

the Railroad Retirement Tax Act ("RRTA") imposes a tax on compensation paid to railroad employees and representatives.[746]

FICA taxes are comprised of two components: the Old-Age, Survivors, and Disability Insurance ("OASDI") and Hospital Insurance ("Medicare").[747] With respect to Medicare taxes, the applicable rate is 2.9 percent with half of such rate (1.45 percent) imposed on the employee and the remainder (1.45 percent) imposed on the employer.[748] The tax is assessed on covered wages, which is defined for Medicare tax purposes as all remuneration for "employment," including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.[749] The name given to the remuneration for employment is immaterial. Medicare wages includes salaries, vacation allowances, bonuses, deferred compensation, commissions, and fringe benefits. The term "employment" is generally defined for FICA tax purposes as any service, of whatever nature, performed by an employee for the person employing him or her, with certain specific exceptions.

The employee portion of Medicare taxes must be withheld and remitted to the Federal government by the employer during the quarter, as required by the applicable deposit rules.[750] The employer is liable for the employee portion of Medicare taxes, in addition to its own share, whether or not the employer withholds the amount from the employee's wages.[751] OASDI and Medicare taxes are generally allocated by statute among separate trust funds: the OASDI Trust Funds, Medicare's Hospital Insurance Trust Fund, and Supplementary Medical Insurance Trust Fund.[752]

[746] Sec. 3221.

[747] The Hospital Insurance tax includes two components: Medicare tax and Additional Medicare tax. Additional Medicare taxes are imposed on wages in excess of certain thresholds and are only imposed on the employee. Sec. 3101(b). There is no employer match for Additional Medicare tax. For purposes of this explanation, when referencing Medicare taxes, the term does not include Additional Medicare tax.

[748] Secs. 3101(b); 3111(b).

[749] Sec. 3121(a).

[750] Sec. 3102(a) and Treas. Reg. sec. 31.3121(a)-2. Sec. 6302.

[751] Sec. 3102(b).

[752] Secs. 201 and 1817 of the Social Security Act, Pub. L. No. 74-271 as amended (42 U.S.C. secs. 401 and 1395i). Section 201, 42 U.S.C. sec. 402. This section appropriates to the OASI and DI trust funds 100 percent "the taxes imposed . . . by chapter 21 (other than sections 3101(b) and 3111(b)[i.e., 3101(a) and 3111(a)]) of the Internal Revenue Code of 1954 with respect to wages (as defined in section 3121 of such Code)" "determined by the Secretary of the Treasury by applying the applicable rates of tax under such subchapter or chapter 21 (other than sections 3101(b) and 3111(b)) to such wages." Accordingly, the amount appropriated is based on the tax rate in effect on wages as defined in the statute. Similarly, section 1817 of the Social Security Act, 42 U.S.C. sec. 1395i, appropriates to the HI trust fund 100 percent of "the taxes imposed by sections 3101(b) and 3111(b) of the Internal Revenue Code of 1986 with respect to wages reported to the Secretary of the Treasury or his delegate pursuant to subtitle F of such Code after December 31, 1965, as determined by the Secretary of the Treasury by applying the applicable rates of tax under such sections to such wages."

Description of Proposal

An eligible local newspaper publisher is allowed a refundable credit against the Medicare taxes imposed on the employer[753] for each calendar quarter in an amount equal to an applicable percentage of wages paid to each local news journalist employee of such employer for such calendar quarter.[754] The applicable percentage of wages eligible for the credit is 50 percent in the case of each of the first four calendar quarters, and 30 percent in the case of each calendar quarter thereafter. The amount of wages which may be taken into account for any calendar quarter shall not exceed $12,500. An eligible employer may also elect not to claim the credit. In addition, no credit is allowed for the United States Government or to an agency or instrumentality thereof.

An eligible local news publisher is, with respect to any calendar quarter, any employer if substantially all of the gross receipts of such employer for such calendar quarter are derived in the trade or business of publishing local newspapers. All persons treated as a single employer under subsection (a) or (b) of section 52, or subsection (m) or (o) of section 414, shall be treated as one employer for purposes of this proposal. This aggregation rule does not apply unless such persons are involved in the production of the same print or digital publication.

The term "local newspaper" means any print or digital publication if (1) the primary content of such publication is original content derived from primary sources and relating to news and current events, (2) such publication primarily serves the needs of a regional or local community, (3) the publisher of such publication employs at least one local news journalist who resides in such regional or local community, and (4) the publisher of such publication employs not more than 750 employees.

An eligible local news journalist is any employee of an eligible local newspaper publisher for any calendar quarter who provides at least 100 hours of services as a local news journalist during such calendar quarter to such eligible local newspaper publisher, during which time such individual regularly gathers, collects, photographs, records, writes, or reports news or information that concerns local events or other matters of local public interest, for such calendar quarter.

The proposal provides that the credit allowed may not exceed the Medicare tax imposed on the employer, reduced by certain payroll tax credits[755] for that calendar quarter on the wages paid with respect to all the employer's employees. However, if for any calendar quarter the amount of the credit exceeds the Medicare taxes imposed on the employer, reduced as described

[753] Sec. 3111(b).

[754] The term "wages" means wages, as defined in section 3121(a) for FICA tax purposes. Any credit allowed under this proposal shall be treated as a credit of the customer of the certified professional employer organization as described in section 3511(d)(2).

[755] Secs. 3131, 3132, 3134, and 6432.

in the prior sentence, such excess is treated as a refundable overpayment.[756] The proposal also includes a denial of double benefit rule.[757] Any credit allowed under this proposal shall be treated as a credit described in section 3511(d)(2) with respect to third-party payors.

The Secretary shall issue such forms, instructions, regulations, and guidance as are necessary to implement the purposes of this section, including the application of the credit to third-party payors and regulations or guidance allowing such payors to submit documentation necessary to substantiate the eligible employer status of employers that use such payors.[758]

Effective Date

The amendments made by this proposal shall apply to calendar quarters during the first five calendar years beginning after the date of enactment.

17. Treatment of financial guaranty insurance companies as qualifying insurance corporations under PFIC rules

Present Law

Present law includes requirements for a corporation the income of which is not included in passive income for purposes of the passive foreign investment company ("PFIC") rules, in the case of certain insurance companies.[759] Passive income for purposes of the PFIC rules generally does not include income derived in the active conduct of an insurance business by a corporation (1) that would be subject to tax under subchapter L if it were a domestic corporation; and (2) the applicable insurance liabilities of which constitute more than 25 percent of its total assets as reported on the company's applicable financial statement for the last year ending with or within the taxable year.[760]

For the purpose of the provision's exception from passive income, applicable insurance liabilities mean, with respect to any property and casualty or life insurance business (1) loss and loss adjustment expenses, (2) reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. This includes loss reserves for property and casualty, life, and health insurance contracts and annuity contracts.

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[756] The excess is treated as an overpayment and refunded under sections 6402(a) and 6413(b). In addition, any amount that is due to an employer is treated in the same manner as a refund due from a credit provision. 31 U.S.C. sec. 1324. Thus, amounts are appropriated to the Secretary of the Treasury for refunding such excess amounts.

[757] Secs. 41, 45A, 45P, 45S, 51, 1396, 3131, 3132, 3134, and 6432.

[758] Third-party payors include professional employer organizations, certified professional employer organizations, or agents under section 3504.

[759] Sec. 1297(b)(2)(B).

[760] Sec. 1297(f)(1)(A) and (B).

Unearned premium reserves with respect to any type of risk are not treated as applicable insurance liabilities for purposes of the provision.

For purposes of the provision, the amount of any applicable insurance liability may not exceed the lesser of such amount (1) as reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation), or (2) as determined under regulations prescribed by the Secretary.

An applicable financial statement is a statement for financial reporting purposes that (1) is made on the basis of generally accepted accounting principles, (2) is made on the basis of international financial reporting standards, but only if there is no statement made on the basis of generally accepted accounting principles, or (3) except as otherwise provided by the Secretary in regulations, is the annual statement required to be filed with the applicable insurance regulatory body, but only if there is no statement made on either of the foregoing bases. Unless otherwise provided in regulations, it is intended that generally accepted accounting principles means U.S. GAAP.

The applicable insurance regulatory body means, with respect to any insurance business, the entity established by law to license, authorize, or regulate such insurance business and to which the applicable financial statement is provided. For example, in the United States, the applicable insurance regulatory body is the State insurance regulator to which the corporation provides its annual statement.

If a corporation fails to qualify solely because its applicable insurance liabilities constitute 25 percent or less of its total assets, a United States person who owns stock of the corporation may elect in such manner as the Secretary prescribes to treat the stock as stock of a qualifying insurance corporation if (1) the corporation's applicable insurance liabilities constitute at least 10 percent of its total assets, and (2) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business, and its failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.[761]

Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure. Additional relevant facts for determining whether the firm is predominantly engaged in an insurance business include: claims payment patterns for the current and prior years; the firm's loss exposure as calculated for a regulator such as the SEC or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the firm. The fact that a firm has been holding itself out as an insurer for a long period is not determinative either way.

Runoff-related or rating-related circumstances include, for example, the fact that the company is in runoff, that is, it is not taking on new insurance business (and consequently has

[761] See Treas. Reg. sec. 1.1297-4(d).

little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books. Such circumstances also include, for example, the application to the company of specific requirements with respect to capital and surplus relating to insurance liabilities imposed by a rating agency as a condition of obtaining a rating necessary to write new insurance business for the current year.

Present law does not specifically state how the treatment of insurance companies under the PFIC rules applies in the case of a financial guaranty insurance company. A financial guaranty insurance company's business is generally to insure the risks related to the default of corporate and governmental bonds. Under NAIC guidelines,[762] a financial guaranty insurer is a monoline company (*i.e.*, does not insure other types of risks). Any financial statements prepared in accordance with generally accepted accounting principles ("GAAP") of a financial guaranty insurer may not report an amount of reserves for losses and loss adjustment expenses until those items are expected to exceed unearned premium reserves with respect to the contract,[763] a situation generally involving imminent or current default of insured bonds.

<u>Description of Proposal</u>

The proposal provides specific rules for financial guaranty insurance companies under the present-law PFIC rules for insurance companies.

Under the proposal, applicable insurance liabilities of a financial guaranty insurance company include unearned premium reserves (notwithstanding the general rule that unearned premium reserves are not included[764]) if the company meets requirements. The requirements are intended to limit the treatment provided under the proposal to insurance companies that are actively engaged in the business of financial guaranty insurance and not in other activities such as, for example, hedge fund investing. The requirements are that (1) the company is prohibited under generally accepted accounting principles from reporting on its financial statement reserves for losses and loss adjustment expenses with respect to a financial guaranty insurance or reinsurance contract, except to the extent that those losses and loss adjustment expenses are expected to exceed the unearned premiums on the contract; (2) the applicable financial statement of the company reports financial guaranty exposure[765] of at least 15-to-1 or State or

[762] The National Association of Insurance Commissioners ("NAIC") issues model laws and model regulations that are frequently enacted (sometimes with modifications) by States for the purpose of their regulation of insurance companies in the State.

[763] See Financial Accounting Standards Board, *FASB Statement No. 60,* interpreting *Statement of Financial Accounting Standards No. 163,* paragraphs 22-28 and B37-38, 2008.

[764] Sec. 1297(f)(3)(A)(ii).

[765] For purposes of this requirement, the term financial guaranty exposure means the ratio of (1) the net debt service outstanding insured or reinsured by the company that is within the single risk limits set forth in the Financial Guaranty Insurance Guideline (as reported on the company's applicable financial statement, to (2) the company's total assets (as so reported). See below for a definition of this Guideline.

local bond exposure[766] of at least 9-to-1 (8-to-1 for a taxable year of the company ending on or before December 31, 2018), and (3) the company includes in its insurance liabilities only its unearned premium reserves relating to insurance written or assumed that is within the single risk limits of section D of subsection 4 of the NAIC's Financial Guaranty Insurance Guideline, as defined in the proposal (modified by using total shareholders' equity as reported on the company's applicable financial statement rather than the aggregate of the surplus to policyholders and contingency reserves).

A financial guaranty insurance company is defined for purposes of the proposal to mean any insurance company the sole business of which is writing or reinsuring financial guaranty insurance that is permitted.[767] For this purpose, financial guaranty insurance means financial guaranty insurance as defined under section 1, subsection (A),[768] of the NAIC's Financial Guaranty Insurance Guideline, which is permitted under section 4, subsection (B), of such Guideline, including single risk limits.[769]

The proposal defines the NAIC's Financial Guaranty Insurance Guideline, which means the October 2008 model regulation that was adopted by the National Association of Insurance Commissioners on December 4, 2007. The determination of whether any provision of this Guideline has been satisfied is made by the Treasury Secretary under the provision.

In addition, a financial guaranty insurance company is treated as satisfying two requirements of the 10-percent facts and circumstances test, described above in the present law section, that (1) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business,[770] and (2) the corporation's failure to qualify

[766] For purposes of this requirement, the term State or local bond exposure means the ratio of (1) the net unpaid principal of State or local bonds (as defined in section 103(c)(1)) insured or reinsured by the company that is within the single risk limits set forth in the Financial Guaranty Insurance Guideline (as reported on the company's applicable financial statement), to (2) the company's total assets (as so reported).

[767] New sec. 1297(f)(3)(C)(iii).

[768] This part of the NAIC Guideline provides, in relevant part, "'Financial guaranty insurance' means a surety bond, an insurance policy or, when issued by an insurer or any person doing an insurance business as defined in Section [insert section], an indemnity contract and any guaranty similar to the foregoing types, under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnitee as a result of any of the following events," which include failure of an obligor to pay when due.

[769] This part of the NAIC Guideline sets forth limitations on the activities of the company; including that the obligations insured by the company must meet a minimum percentage of investment grade obligations, that the company must meet aggregate risk limits by maintaining surplus to policyholder and contingency reserves that meet specified percentages for identified types of insured obligations, and that the company must meet single risk limits (limits on exposure to losses from single risks) by conforming to specified percentages with respect to specified categories of insured obligations.

[770] A financial guaranty insurance company, to be eligible for this treatment, separately must meet the statutory definition that relies on the criteria of the NAIC Guideline on which State insurance regulators generally rely to identify such a company. Thus, permitting this treatment in the case of a company meeting those requirements is considered unlikely to lead to avoidance of the purposes of section 1297(f). It is intended that the Treasury Secretary provide guidance consistent with preventing avoidance.

under the 25 percent threshold[771] is due solely to runoff-related or rating-related circumstances involving such insurance business.[772] Treating a financial guaranty insurance company as satisfying these particular requirements of the 10-percent facts and circumstances test, however, does not treat the company as having satisfied the requirement for that test that its applicable insurance liabilities constitute at least 10 percent of its total assets.[773]

The provision requires reporting. An amount is treated as reported on an applicable financial statement for purposes of the provision if the amount is separately reported on that statement with respect to the corporation, or the amount is separately determined for purposes of calculating an amount that is reported on that statement. In addition, regulatory authority is provided to require reporting to the IRS or the Treasury Department such information as the IRS or Treasury require, in the case of each United States person who owns an interest in a specified non-publicly traded foreign corporation. A non-publicly traded foreign corporation is defined as any foreign corporation that would be a PFIC if section 1297(b)(2)(B) did not apply, and no interest in which is traded on an established securities market.

Effective Date

The provision generally is effective as if included with the enactment of section 1297(f) and of modifications to section 1297(b)(2)(B), that is, for taxable years beginning after December 31, 2017. The reporting of certain items under the provision is effective for reports made after the date of enactment of this provision.

18. Credit for qualified access technology for the blind

Present Law

Additional amount of the standard deduction for the aged or blind

The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction.[774] The amount of the basic standard deduction varies depending upon a taxpayer's filing status. For 2021, the amount of the basic standard deduction is $12,550 for a single individual and a married individual filing a separate return, $18,800 for a head of household, and $25,100 for a joint return and a surviving spouse.[775] An additional standard

[771] Sec. 1297(f)(1).

[772] Sec. 1297(a)(2)(B). By treating the company as meeting these particular requirements of the 10-percent facts and circumstances test, the provision treats a financial guaranty insurance company similarly to an insurance company whose failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

[773] Sec. 1297(f)(2)(A).

[774] Sec. 63(c).

[775] Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

deduction is allowed to an individual who is elderly (has attained age 65 before the close of the taxable year) or blind.

For 2021, the additional amount is $1,350 for a married taxpayer (for each spouse meeting the applicable criteria in the case of a joint return) and surviving spouses. The additional amount for single individuals and heads of households is $1,700. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2021) of $2,700 or $3,400, as applicable.[776]

An individual is considered blind for purposes of the additional amount of the standard deduction only if the individual's central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if the individual's visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.[777]

Under present law, there is no credit for qualified access technology for the blind.

Description of Proposal

The proposal creates a new refundable credit for amounts paid or incurred during the taxable year by the taxpayer for qualified access technology for use by a qualified blind individual who is the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer.

The aggregate amount of the credit allowed under the proposal with respect to any qualified blind individual shall not exceed $2,000 in any period that consists of three consecutive taxable years. The $2,000 amount is adjusted for inflation for taxable years beginning after 2022. Amounts eligible for the credit may not be compensated for by insurance or otherwise.

A qualified blind individual has the same meaning as an individual who is blind for purposes of the additional amount of the standard deduction for the blind.[778] Qualified access technology means hardware, software, or other information technology the primary function of which is to convert or adapt information which is visually represented into forms or formats useable by blind individuals.

No credit is allowed under the proposal for any expenses for which a deduction or credit is allowed under Chapter 1 of the Code.

The credit shall not apply to amounts paid or incurred in taxable years beginning after December 31, 2026.

[776] Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

[777] Sec. 63(f)(4).

[778] *Ibid.*

Effective Date

The provision is effective for taxable years beginning after December 31, 2021.

19. Modification of REIT constructive ownership rules

Present Law

In general

To qualify as a REIT, an entity must meet a number of requirements. Among other requirements, an entity must meet the 75-percent income test and the 95-percent income test.[779] For purposes of both income tests, qualifying rents constitute qualifying gross income.[780]

Rents from a related party – generally otherwise qualifying rents received from corporate or noncorporate tenants in which the REIT, directly or indirectly, has an ownership interest of 10 percent or more – are generally not treated as qualifying rents.[781] Additionally, where a REIT furnishes or renders services to a tenant, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor.[782] In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT.[783]

Constructive ownership rules

For purposes of determining a REIT's ownership interest in a tenant and whether a contractor is independent, the constructive ownership rules of section 318(a), with certain modifications, apply.[784]

Section 318(a) provides rules setting forth when stock is constructively owned. Stock may be attributed *from* partnerships, estates, trusts, and corporations to persons owning interests in such entities under so-called "upward" attribution rules.[785] Stock may be attributed *to* partnerships, estates, trusts, and corporations from persons owning interest in such entities under

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[779] Secs. 856(c)(2) and 856(c)(3).

[780] Secs. 856(c)(2)(C) and 856(c)(3)(A).

[781] Sec. 856(d)(2)(B).

[782] Secs. 856(d)(2)(C) and 856(d)(7).

[783] Sec. 856(d)(3).

[784] Sec. 856(d)(5).

[785] Sec. 318(a)(2).

so-called “downward” attribution rules.[786] Stock may be considered owned in certain other cases. Section 318(a), moreover, contains operating rules.

Under section 856(d)(5), the constructive ownership rules of section 318(a) are modified in three ways. First, such rules (“modified section 318(a)”) apply to determine the ownership of assets and net profits of any person (*i.e.*, interests in noncorporate entities), as well as stock.[787]

Second, certain thresholds in the “upward” and “downward” attribution rules are modified such that attribution from and to corporations occurs in a greater number of situations. Specifically, 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3).[788] Thus, under section 318(a)(2)(C), as modified (“modified section 318(a)(2)(C),” with sections 318(a)(2)(B) and 318(a)(2)(C), the “modified upward attribution rules”), if 10 or more percent of a REIT or other corporation is owned, directly or indirectly, by or for a person, that person is treated as owning a proportionate share of any stock, assets or net profits owned, directly or indirectly, by the REIT or other corporation. Under section 318(a)(3)(C), as modified (“modified section 318(a)(3)(C)”), if 10 or more percent of a REIT or other corporation is owned, directly or indirectly, by or for a person, that REIT or other corporation is treated as owning the stock, assets, or net profits owned, directly or indirectly, by or for the person.

Third, a threshold in the downward attribution rules is modified such that attribution to partnerships occurs in a fewer number of situations. Specifically, section 318(a)(3)(A) is applied in the case of a partnership by taking into account only partners who own, directly or indirectly, 25 percent or more of the capital interest, or the profit interest, in the partnership.[789] Thus, under section 318(a)(3)(A), as modified (“modified section 318(a)(3)(A),” with section 318(a)(3)(B) and modified section 318(a)(3)(C), the “modified downward attribution rules”), stock, assets, and net profits owned, directly or indirectly, by or for a partner are considered owned by the partnership when that partner owns, directly or indirectly, a 25 percent or greater capital interest or profits interest in the partnership.

The examples below illustrate the application of modified section 318(a) under present law.

<u>Example 1</u>: Assume that 25 percent of the shares in a REIT (“REIT”) are owned by a person (“A”) who owns a 25 percent interest in a partnership (“P1”); another person (“B”) owns a 25 percent interest in P1 and a 25 percent interest in another partnership (“P2”); and a third person (“C”) owns a 25 percent interest in P2 and a 25 percent interest in a partnership that is a tenant of REIT (“T”). Because of successive applications of the modified downward attribution rules,

[786] Sec. 318(a)(3).

[787] Sec. 856(d)(5) (flush language).

[788] Sec. 856(d)(5)(A).

[789] Sec. 856(d)(5)(B).

REIT is considered to own 25 percent of T, and the rents paid by T are non-qualifying rents from a related party to REIT.

Example 2: Assume a person ("A") owns 100 percent of the shares in a corporation ("Parent"); Parent owns 100 percent of the shares in a second corporation ("Sub"); and Sub owns 10 percent of the shares in a REIT ("REIT"). Further assume A owns 100 percent of the shares in a corporation that is a tenant of REIT ("T"). Because of successive applications of the modified downward attribution rules or successive applications of the modified upward attribution rules followed by a single application of the modified downward attribution rules, REIT is considered to own 10 percent of T, and the rents paid by T are non-qualifying rents from a related party to REIT.

Example 3: Assume that 40 percent of the shares in a REIT ("REIT") are owned by a person ("A") who owns a 25 percent interest in a partnership ("P1"); another person ("B") owns a 25 percent interest in P1 and a 25 percent interest in a second partnership ("P2"); a third person ("C") owns a 25 percent interest in P2 and a 25 percent interest in third partnership ("P3"); and a fourth person ("D") owns a 25 percent interest in P3 and 40 percent of the shares in a corporation that is a contractor of REIT ("Contractor"). Because of successive applications of the modified downward attribution rules, the independent contractor definition will not be met: P1, P2, and P3 will be considered to own more than 35 percent interests in both REIT and Contractor.

Example 4: Assume that 50 percent of the shares in a REIT ("REIT") are owned by a person ("A") who owns 10 percent of the shares in a corporation ("Corp"), and another person ("B") owns 10 percent of the shares in Corp and 50 percent of the interests in a partnership that is a contractor of REIT ("Contractor"). Corp will be considered to own more than 35 percent of REIT stock and more than 35 percent of Contractor interests as a result of two applications of the modified downward attribution rules. The independent contractor definition will not be met because Corp will be considered to own more than 35 percent interests in both REIT and Contractor.

Description of Proposal

The proposal modifies the constructive ownership rules that apply for purposes of determining a REIT's ownership interest in a tenant and whether a contractor is independent by amending section 856(d)(5).

Under the proposal, stock, assets, and net profits constructively owned by a partnership, estate, trust, or corporation by reason of the application of section 318(a)(3) (as modified by sections 856(d)(5)(A) and 856(d)(5)(B)) (*i.e.*, the modified downward attribution rules) are not considered as owned by such entity for purposes of again applying such section (*i.e.*, the modified downward attribution rules) in order to make another person the constructive owner of such stock, assets, or net profits. Thus, the provision prevents multiple applications of the modified downward attribution rules in certain situations. The situations are limited to scenarios where the successive application of the modified downward attribution rules would otherwise make a second person the constructive owner of stock or an interest in a noncorporate entity. Said differently, the provision only prevents the successive application of the modified downward attribution rules where (1) an application of the modified downward attribution rules makes a person the constructive owner of stock or an interest in a noncorporate entity, and (2) such person's constructive ownership is attributed to a different person by virtue of an additional application of the modified downward attribution rules. The provision does not cover scenarios where two applications of the modified downward attribution rules make the same person the constructive owner of, for example, a REIT and a contractor.[790]

The provision does not prevent any person from being the constructive owner of stock, assets, or net profits of any person as the result of any other application of modified section 318(a) (the "other application exception"). Thus, if there exist two (or more) applications of modified section 318(a) that result in a person constructively owning stock or an interest in a noncorporate entity and one (or more) application of modified section 318(a) does not require the successive application of the modified downward attribution rules in the manner described above, that person will be treated as a constructive owner.[791]

The Secretary is authorized to circumscribe the situations to which the provision applies. This is intended to ensure that a REIT and a tenant, as well as a REIT and a contractor, are treated as related in appropriate situations such that REITs retain their character as passive investment vehicles.[792]

No inference is created by the proposal with respect to the application of section 318 outside the context of the proposal.

The examples below illustrate the application of modified section 318(a), as amended by the provision.[793]

Example 1: Assume that 25 percent of the shares in a REIT ("REIT") are owned by a person ("A") who owns a 25 percent interest in a partnership ("P1"); another person ("B") owns a 25 percent interest in P1 and a 25 percent interest in another partnership ("P2"); and a third person ("C") owns a 25 percent interest in P2 and a 25 percent interest in a partnership that is a tenant of REIT ("T"). Under the provision, the REIT stock constructively owned by P1 (as a result of an application of the modified downward attribution rules) is not taken into account when again applying the modified downward attribution rules to make another person (P2 or T) a constructive owner. Likewise, interests in T constructively owned by P2 (as a result of an application of the modified downward attribution rules) are not taken into account when again applying the modified downward attribution rules to make another person (P1 or REIT) a

[790] See Example 4, below.

[791] See Example 2, below.

[792] Congress created REITs as passive investment vehicles. See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6 ("[O]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.").

[793] The facts of these examples are the same as the facts of the examples in the present law section, above.

constructive owner. Thus, under the provision, unlike under present law, REIT is not considered to own interests in T, and the rents paid by T may be qualifying rents to REIT.

Example 2: Assume a person ("A") owns 100 percent of the shares in a corporation ("Parent"); Parent owns 100 percent of the shares in a second corporation ("Sub"); and Sub owns 10 percent of the shares in a REIT ("REIT"). Further assume A owns 100 percent of the shares in a corporation that is a tenant of REIT ("T"). REIT would be considered to own 10 percent of T as a result of successive applications of the modified downward attribution rules in a manner that would be precluded by the provision but for the other application exception. However, successive applications of the modified upward attribution rules followed by a single application of the modified downward attribution rules also result in REIT constructively owning 10 percent of T. Thus, under the provision, like under present law, REIT is considered to own 10 percent of T, and the rents paid by T are non-qualifying rents from a related party to REIT.

Example 3: Assume that 40 percent of the shares in a REIT ("REIT") are owned by a person ("A") who owns a 25 percent interest in a partnership ("P1"); another person ("B") owns a 25 percent interest in P1 and a 25 percent interest in a second partnership ("P2"); a third person ("C") owns a 25 percent interest in P2 and a 25 percent interest in third partnership ("P3"); and a fourth person ("D") owns a 25 percent interest in P3 and 40 percent of the shares in a corporation that is a contractor of REIT ("Contractor"). Under the provision, the REIT stock constructively owned by P1 (as a result of an application of the modified downward attribution rules) is not taken into account when again applying the modified downward attribution rules to make another person (P2, P3, or Contractor) a constructive owner. Likewise, the Contractor stock constructively owned by P3 (as a result of an application of the modified downward attribution rules) is not taken into account when again applying the modified downward attribution rules to make another person (P2, P1, or REIT) a constructive owner. Thus, under the provision, no person will be considered to own more than a 35 percent interest in both REIT and Contractor, and the independent contractor definition may be met.

Example 4: Assume that 50 percent of the shares in a REIT ("REIT") are owned by a person ("A") who owns 10 percent of the shares in a corporation ("Corp"), and another person ("B") owns 10 percent of the shares in Corp and 50 percent of the interests in a partnership that is a contractor of REIT ("Contractor"). Based on A's actual ownership of REIT and one application of the modified downward attribution rules, Corp will be considered to own more than 35 percent of REIT stock. Based on B's actual ownership of Contractor and one application of the modified downward attribution rules, Corp will be considered to own a more than 35 percent interest in Contractor. Because the second application of the modified downward attributions rules makes the same person (rather than another person) the constructive owner of REIT stock and Contractor interests, under the provision, like under present law, the independent contractor definition will not be met.

Effective Date

The provision applies to taxable years ending after the date of enactment.