
Overview of Ways and Means Chairman Camp's tax reform discussion draft

February 28, 2014

In brief

House Ways and Means Chairman Dave Camp (R-MI) on February 26, 2014 released a 979-page "Tax Reform Act of 2014" discussion draft.

Chairman Camp's draft proposes to lower corporate and individual tax rates, reform US international tax rules, and simplify the tax code. Chairman Camp said he hopes his draft legislation will lead to the first comprehensive overhaul of the US tax code since the Tax Reform Act of 1986.

Below is a general summary of select business and individual tax reform proposals in Chairman Camp's discussion draft (the "Draft"), along with links to detailed explanations and revenue estimates released by the Ways and Means Committee and the Joint Committee on Taxation.

We will be providing additional analysis of the Draft in coming PwC Insights. For an outline of the Draft, see our February 26 [WNTS Insight](#).

In detail

Business tax reform proposals

Corporate tax

Under Chairman Camp's draft, the current 35-percent top corporate rate is reduced over five years to 25 percent. A transition rule sets the rate for taxable income up to \$75,000 to 25 percent beginning in 2015, with the rate on income above that level phased down by two percentage points each year from 2015 through 2019.

The corporate alternative minimum tax (AMT) is repealed.

Domestic production activities deduction

Under current law, a taxpayer may claim a deduction under Section 199 for certain qualified production activities performed in whole or in significant part within the United States, subject to a W-2 wage limitation. The deduction is computed as a percentage (generally nine percent) of the lesser of a taxpayer's qualified

production activities income or taxable income.

The Draft repeals Section 199 for taxable years beginning after December 31, 2016, and reduces the applicable percentage for 2015 and 2016 to six percent and three percent, respectively.

Note: For individuals, including individuals who are partners and shareholders of pass-through entities, a new exclusion similar to Section 199 is provided for the purpose of determining individual taxable income, as discussed below.

Depreciation of tangible property

The Draft contains proposals that are designed to better reflect the economic useful lives of depreciable property by adopting depreciation methods similar to those currently used under the alternative depreciation system (ADS) in place of the existing modified accelerated cost recovery system (MACRS) depreciation rules. Specifically, the Draft proposes a straight-line depreciation method for tangible property with an applicable recovery period equal to the class life of the property. The Draft assigns a recovery period for certain property (e.g., five years for qualified technological equipment, 12 years for property without a class life, 12 years for airplanes, and 40 years for real property) and relies on the Treasury Department to determine the class lives for all other property.

Observation: Under current law, asset class lives generally are prescribed in Rev. Proc. 87-56. However, since 1988, the Treasury Department has lacked the authority to update these asset classifications, resulting in uncertainty in classifying assets and in recovery periods that are outdated and not reflective of the anticipated useful lives of assets. The Draft gives the Treasury Department the authority to change these historic asset classes, and requires it to develop, in conjunction with the Bureau of Economic Analysis, a new schedule of economic depreciation, report to Congress with recommended class lives no later than December 31, 2017, and revise IRS guidance containing asset class lives.

Under the Draft, a taxpayer could elect to take into account inflation by applying an inflation adjustment percentage to the modified adjusted basis of depreciable personal property in its annual depreciation deduction. Importantly, the overall depreciation

allowance (including the inflation adjustment) may not exceed the adjusted basis of the property as of the beginning of the taxable year.

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

Amortization of research and experimental expenditures

The Draft repeals expensing of research and experimental (R&E) expenditures, including software development costs, under Section 174 and requires such expenditures to be capitalized and amortized ratably over a five-year period. However, R&E expenditures that are attributable to research that is conducted outside the United States must be capitalized and amortized over a period of 15 years. In addition, the optional 10-year recovery of these costs for alternative minimum tax (AMT) purposes under Section 59(e) is repealed.

Observation: Treating software development costs as R&E expenditures for purposes of Section 174 effectively revokes Revenue Procedure 2000-50, under which taxpayers may expense certain software development costs.

A transition rule is provided for domestic R&E expenditures paid or incurred during any taxable year beginning before 2021. For taxable years beginning in 2015, 60 percent of the R&E expenditures are allowed as a deduction; the remaining amount must be capitalized and amortized over a two-year period. This percentage decreases to 40 percent in 2016 and 2017, and the remaining amount is capitalized and amortized over a three-year period. In 2018, 2019, and 2020 the percentage decreases to 20 percent, with the remaining amount capitalized and amortized over a four-year period.

Observation: According to the House Ways and Means summary of

the Draft, this formula is intended to permit a deduction of at least 80 percent of the amount that is deductible under current law (assuming constant levels of annual expenditures).

Research credit

The research credit would be modified and made permanent, effective for tax years beginning after 2013, and for amounts paid and incurred after 2013.

The Draft adopts the current-law alternative simplified credit (ASC) computation, repealing the current-law general 20-percent credit, as well as the 20-percent credit for amounts paid for basic research and the 20-percent credit for amounts paid to an energy consortium. The research credit would equal (1) 15 percent of qualified research expenses for the tax year that exceed 50 percent of the average qualified research expenses for the tax year for which the credit is determined, plus (2) 15 percent of the basic research payments for the tax year that exceed 50 percent of the average basic research payments for the three tax years preceding the tax year for which the credit is determined.

The Draft also retains the current law ASC provision that allows a taxpayer to claim a reduced research credit if the taxpayer has no qualified research expenses in any one of the three preceding tax years.

Amounts paid for supplies or with respect to computer software would no longer qualify as qualified research expenses.

Observation: The Ways and Means section-by-section summary of the computer software provision is unclear as to the scope of the limitation. However, the statutory language appears to eliminate from the definition of “qualified research”

any research with respect to computer software.

In addition, the Draft repeals certain current special rules related to payments made to qualified research consortiums and eligible small businesses, universities, and Federal laboratories that qualify as contract research expenses. Qualified contract research expenses continue to be subject to a 65-percent inclusion rule.

The Draft also repeals the election to claim a reduced research credit in lieu of reducing deductions otherwise allowed.

Amortization of advertising expenditures

Under current law, advertising expenses generally are deductible as ordinary and necessary business expenses in the year in which they are paid or incurred. For taxable years beginning in 2015, the Draft requires a taxpayer to capitalize and amortize 20 percent of its otherwise deductible advertising expenses over ten years. This percentage increases to 30 percent in 2016, 40 percent in 2017, and 50 percent in 2018 and thereafter. A taxpayer's remaining advertising expenditures are deductible in the year paid or incurred. However, the Draft provides an exemption from these capitalization requirements for taxpayers with advertising expenses for the taxable year of \$1 million or less, subject to a phase-out.

The term "otherwise deductible advertising expense" generally means the deductions that would (but for this proposed rule) be allowable to the taxpayer for such taxable year with respect to "specified advertising expenses." A "specified advertising expense" generally is defined as any amount paid or incurred for the development, production, or placement (including any form of transmission, broadcast, publication, display, or distribution) of any communication to the general public

(or portions thereof) that is intended to promote the taxpayer or a trade or business of the taxpayer, including any service, facility, or product provided as part of such trade or business.

Observation: The Draft likely will increase complexity by requiring taxpayers to track advertising expenditures separately from other related costs that remain currently deductible, and lead to controversy as to what constitutes a "specified advertising expense."

Inventory accounting methods

The repeal of the last-in, first-out (LIFO) inventory method of accounting has been considered in recent tax reform proposals. Consistent with those proposals, the Draft repeals use of the LIFO inventory method. The Draft requires taxpayers that currently are using a LIFO method to revalue their beginning inventory using a first-in, first-out (or other permissible) method in the first taxable year beginning after December 31, 2014.

Also similar to other proposals, the Draft repeals use of the lower-of-cost-or-market (LCM) method to value ending inventory and prohibits any write-downs to "bona fide net selling prices" for subnormal goods (i.e., goods that are unusable or unsalable in the normal way). As a result, the Draft requires inventory to be valued at cost.

In general, any taxpayer required to change its method of accounting from LIFO, LCM, or a method of valuing subnormal goods at bona fide net selling prices to comply with the Draft is allowed to take any net positive Section 481(a) adjustment into account over four taxable years, beginning with the taxpayer's first taxable year beginning after December 31, 2018. The net positive Section 481(a) adjustment is taken into

account on the basis of 10 percent, 15 percent, 25 percent, and 50 percent for the first, second, third, and fourth taxable year of such period, respectively. Alternatively, a taxpayer could elect to begin this four-year inclusion period in an earlier taxable year.

Observation: Other recent LIFO repeal proposals would spread the Section 481(a) adjustment period over a more extended period, but starting at the same date that use of the LIFO inventory method is repealed. For example, the November 2013 Senate Finance Committee staff discussion draft on cost recovery and tax accounting issued under former Finance Chairman Max Baucus (D-MT) proposed an eight-year adjustment period beginning in 2015. President Obama's FY 2014 budget included a LIFO repeal proposal with a 10-year adjustment period beginning in 2014. Although the Draft requires the Section 481(a) adjustment to be picked up over four taxable years, the back-loaded Section 481(a) adjustment is more favorable than previous proposals and should provide some relief for taxpayers that would be required to recapture a LIFO reserve.

For more on the Finance Committee staff cost recovery and tax accounting discussion draft, see the November 21, 2013 [*WNTS Insight*](#).

The Draft provides an exception to the general rule for the Section 481(a) adjustment for a change from LIFO by "closely-held entities" (as defined in the Draft, but generally an eligible domestic corporation or partnership with 100 or fewer individual shareholders or partners). Under this exception, only 20 percent (28 percent in the case of a C corporation) of a closely held entity's net positive Section 481(a) adjustment must be included in income beginning with the same taxable year described above.

Observation: The treatment of the net positive Section 481(a) adjustment for the change from LIFO by closely held entities is unique in that the Draft requires only 20 percent of the adjustment to be recognized into income, leaving the remaining 80 percent permanently excluded from income. As a result, the proposal creates a permanent difference for an otherwise temporary item for eligible entities. Based on the House Ways and Means summary of the Draft, it appears that this exclusion was intended to subject the LIFO reserves of closely held entities to a reduced rate of tax not to exceed seven percent (i.e., 20 percent taxed at an individual rate of 35 percent or 28 percent taxed at a corporate rate of 25 percent).

Net operating losses

Under current law, corporations may carry back a net operating loss (NOL) two years and carry forward an NOL 20 years to offset taxable income in such years. The Draft proposes to limit a corporation's ability to utilize its NOL deduction to 90 percent of taxable income (determined without regard to the deduction), similar to the rule currently applicable to AMT NOLs. In addition, the Draft repeals special NOL carryback provisions (e.g., NOLs attributable to specified liability losses) other than the provision relating to certain casualty and disaster losses. The proposal generally would be effective for tax years beginning after 2014, and losses incurred after 2014 and carried back to prior years.

Like-kind exchange rules

Under current law, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is held for productive use in a trade or business or for investment. In a qualifying like-kind exchange, the basis in the new property equals the

taxpayer's adjusted basis in the exchanged property, thus deferring any gain inherent in the exchanged property. The Draft repeals the like-kind exchange rules for transfers after December 31, 2014, with an exception provided for written binding contracts entered into before January 1, 2015, if such transfer is completed before January 1, 2017.

Amortization of intangible assets

The Draft extends the recovery period for amortizable Section 197 intangibles from 15 years to 20 years for property acquired after December 31, 2014. In addition, the exception to the definition of a "Section 197 intangible" for mortgage servicing rights is repealed.

Observation: Repealing the exclusion of mortgage servicing rights from the definition of a Section 197 intangible is a significant change from current law. Under current law, mortgage servicing rights are explicitly excluded from Section 197 and amortized under Section 167 over a 108-month period.

The Draft also directs the Treasury Department to revise the regulatory safe harbor providing 15-year amortization to certain intangibles, generally applicable to intangibles without a prescribed recovery period or a determinable useful life, to require amortization of such intangibles over 20 years.

Overall cash method of accounting

Under the Draft, the overall cash method of accounting may be used only by a natural person (i.e., sole proprietors), a farming business (subject to Section 447), and any other entity (except tax shelters) with average annual gross receipts of \$10 million or less (based on the prior three taxable years). Thus, the Draft eliminates the current exceptions for S corporations, partnerships (without C corporation partners), and qualified

personal service corporations (QPSC) to use the cash method of accounting, unless they satisfy the gross receipts test. All businesses that do not meet the gross receipts test (as well as tax shelters) must use an overall accrual method of accounting.

A taxpayer required to change from an overall cash method of accounting to an overall accrual method of accounting may take any net positive Section 481(a) adjustment into account over four taxable years beginning with the earlier of the taxpayer's elected taxable year or the taxpayer's first taxable year beginning after December 31, 2018. The net positive Section 481(a) adjustment is taken into account on the basis of 10 percent, 15 percent, 25 percent, and 50 percent for the first, second, third, and fourth taxable year of such period, respectively. Alternatively, a taxpayer could elect to begin this four-year inclusion period in an earlier taxable year.

Observation: The requirement for taxpayers with average annual gross receipts in excess of \$10 million to use an overall accrual method regardless of entity form is consistent with a similar proposal included in Chairman Camp's March 2013 small business tax reform discussion draft and, more recently, the November 2013 Senate Finance Committee staff cost recovery and tax accounting reform discussion draft.

Taxable year of inclusion

Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. In general, a taxpayer has a fixed right to receive income under Section 451 at the earlier of when such amount is due to, paid to, or earned by the taxpayer. As a result, income that is due or paid in advance of being

earned (an advance payment) generally must be recognized, unless an exception permits deferral or exclusion. In contrast, an amount not due or paid is not required to be recognized unless it is otherwise earned for tax purposes, regardless of whether the amount was recognized in the taxpayer's applicable financial statement (i.e., as an unbilled receivable).

The Draft revises the rules with respect to the recognition of income and requires taxpayers to recognize income no later than the taxable year in which such income is taken into account as income on an audited financial statement or another financial statement under rules specified by the Treasury Department. In addition, the proposal generally codifies the deferral provisions for advance payments for goods and services under Revenue Procedure 2004-34. That is, a taxpayer that receives advance payments during the taxable year may recognize such advance payment in gross income upon receipt, or to the extent such advance payment is not recognized in the taxpayer's audited financial statement (or other financial statement) may defer the recognition of such advance payment in gross income until the next succeeding taxable year. The JCT explanation to the Draft indicates that this proposal is intended to override the exception to the two-year (or longer) deferral for advance payments received for the sale of goods available to taxpayers under current regulations.

Observation: The Draft will accelerate the recognition of revenue to the extent it eliminates instances in which taxpayers may have been eligible to recognize revenue later than when recognized for financial statement purposes (e.g., unbilled receivables for services or licensed property where revenue is not earned for tax purposes) or were eligible to

defer advance payments longer than the one-year deferral permitted under Revenue Procedure 2004-34.

Other business and accounting method proposals include the following:

- Section 118 exclusion for nonshareholder capital contributions is repealed.
- The Draft expands the income forecast method recovery period to 20 years and requires participations and residuals to be excluded from basis and deducted when paid.
- Section 181 is repealed. Amounts paid or incurred to produce any film or television program generally must be capitalized under Section 263A and recovered under Section 167.
- Section 173 is repealed. The Draft requires taxpayers to capitalize specified circulation expenditures and amortize such expenditures over a 36-month period.
- Package design costs will be excluded from capitalization under new Section 177. However, the Draft requires the taxpayer to treat such costs as allocable indirect costs for purposes of Section 263A with respect to packages that utilize such design.
- The maximum amount that a taxpayer may expense under Section 179 is \$250,000 of the cost of qualifying property placed in service in the taxable year. The \$250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000. The \$250,000 and \$800,000 amounts are indexed

for inflation for taxable years beginning after 2014.

- Section 198 is modified to require qualified environmental remediation expenditures to be capitalized and amortized over a 40-year period.
- Sections 195, 248, and 709 addressing start-up expenditures and organizational expenditures are consolidated into a single provision.
- The Draft proposes to except taxpayers that produce or acquire real or tangible personal property, and that otherwise satisfy the average annual gross receipts test of \$10 million or less for the preceding three-taxable years, from the requirements to capitalize additional costs under Section 263A.
- Section 274 is modified to provide that no deduction is allowed for the cost of entertainment, amusement, or recreation that is directly related to the active conduct of a taxpayer's trade or business.
- Section 453 is modified to remove the exception to the dealer disposition rules for farm property and timeshares and residential lots. In addition, the Draft repeals the present-law \$5 million floor for the imposition of the special rule for interest payments under Section 453A.
- Sections 455, 456, and 458 addressing certain deferral provisions relating to prepaid subscription income, prepaid dues income, and returns for magazines, paperbacks, and records, respectively, are repealed.

- Use of the completed contract method is limited to small construction contractors (contracts completed within two years by taxpayers with gross receipts of \$10 million or less). Accordingly, taxable income from home construction, residential, and ship-building contracts must be accounted for using the percentage-of-completion method under Section 460.
- Section 1235 addressing a special rule for the sale or exchange of patents is repealed.

International tax

As in Chairman Camp's 2011 international tax reform discussion draft, the Draft includes a 95-percent dividends received deduction (DRD) for eligible foreign-source dividends and a 'toll tax' on pre-effective date undistributed foreign earnings and profits (E&P) of US-owned foreign corporations, as well as 'anti-base erosion' rules.

Although some central elements of the Draft's international proposals are similar to the 2011 draft, there are significant changes:

- The Draft's DRD regime applies to all foreign corporations owned at least 10 percent by a US corporation. The 2011 version would have made these rules elective for 10/50 companies.
- Unlike the 2011 proposal, the Draft does not extend the 95-percent exemption regime to foreign branches of US corporations. Exempt dividends reduce a US corporation's stock basis in the foreign subsidiary for purposes of determining losses (but not gains).

- Unlike the 2011 proposal, there is no special provision for taxing the sale of foreign subsidiary stock.
- The one-year holding period in the 2011 proposal is reduced to six months in the Draft, but S corporations and US partnerships (and their respective owners) remain ineligible for the DRD.

As in the 2011 proposal, the Draft does not allocate deductions to the exempt dividends.

For more on the earlier international tax reform draft, see the November 1, 2011 [WNTS Insight](#).

Observation: The changes reflected in the Draft may simplify transition into the new proposed international tax regime.

Note: The draft does not change 'check-the-box' rules.

Toll tax

The Draft's 'toll tax' transition rule applies to foreign subsidiaries' post-1986 historical earnings and profits (E&P) not previously subject to US federal income tax. As in the 2011 proposal, 10 percent (or more) US shareholders (whether or not corporations) include in income their pro rata share of current and accumulated E&P in their last tax year beginning before 2015, which would be taxed at current rates. The Draft differs in bifurcating the E&P into (1) cash and other short-term assets and (2) amounts reinvested in the business. The Draft deducts 75 percent of the cash portion from taxable income (thus taxing the corresponding E&P at an 8.75-percent rate), as well as 90 percent of the reinvested portion (thus taxing the corresponding E&P at 3.5 percent). Foreign tax credits (FTCs) are partially available to offset the US tax.

As in the 2011 version, companies will have eight years to pay the tax for the

deemed inclusion, but the Draft liberalizes the requirement by providing a schedule of required payment percentages that is significantly back-loaded, and by requiring no interest on the deferred payments. The Draft also differs from the 2011 proposal in permitting companies to net their aggregate foreign subsidiary E&P deficits against positive aggregate E&P.

Note: The 'toll tax' proceeds are dedicated to the Highway Trust Fund to fund surface transportation programs. According to Joint Committee on Taxation staff, \$125 billion would be deposited into the Trust Fund.

S corporations also are subject to the Draft's toll tax, with the net amount flowing up to shareholders. S corporation shareholders can electively defer the tax liability on that deemed inclusion until a 'triggering event' occurs (e.g., the S corporation's termination or disposition). The interaction of the 'toll tax' and S corporation mechanics creates some uncertainty about the impact of the 75-percent and 90-percent deductions (referenced above) on S corporation distributions. There are no special rules for partnerships.

Observation: The Draft's transition rule softens the deemed inclusion's impact from the original proposal where foreign subsidiaries generally have reinvested their E&P. The special S corporation rules contain some ambiguity, and the lack of special partnership rules could create additional uncertainty.

Base erosion

The 2011 draft included three anti-base erosion subpart F options. The Draft adopts a modified 'carrot-and-stick' proposal that differs significantly from the 2011 Option C.

The Draft would create a category of foreign base company intangible income (FBCII) subject to subpart F income inclusion if it is taxed at a foreign effective rate below 15 percent:

- FBCII from foreign-directed goods and services would be subject to US federal income tax at the same 15-percent rate, whether earned directly by a US company or by a foreign subsidiary.
- FBCII that does not derive from foreign-directed goods and services would be subject to US federal income tax at the full US corporate rate.
- Significantly, the taxable base for FBCII begins with all adjusted gross income (other than income derived from certain commodities), with a deduction only for 10 percent of the CFC's depreciable tangible asset basis. Unlike 2011 Option C, the mechanics include no specified connection to intangibles.

Observation: This restrictive new subpart F proposal may substantially expand subpart F taxation. The approach taken seeks to provide incentives for US companies to keep intangibles in the US by leveling the playing field between US-controlled intangibles owned in a US company and in a foreign subsidiary.

Other changes

The Draft departs from the 2011 proposal in several other important regards. With respect to significant subpart F provisions, the controlled foreign corporation (CFC) look-through rule is made permanent. The Draft extends the full subpart F active financing exception for five years with respect to qualified income earned at a foreign effective rate at least 50 percent of the maximum US corporate

rate (i.e., 12.5 percent after the phase-in period of the proposed 25-percent rate). In addition, 50 percent of otherwise qualified income is eligible for the exception (i.e., income earned at a foreign effective rate below 50 percent of the maximum US corporate rate).

Under the Draft, the high-tax exception threshold for subpart F income treatment changes, and the exception becomes mandatory, rather than elective. For foreign base company sales income (FBCSI), the high-tax exception applies to income earned at foreign effective tax rate that is 50 percent or more of the maximum corporate US rate (i.e., 12.5 percent after the 25-percent rate phase-in). For FBCII, as noted above, the exception applies at a foreign effective rate of 15 percent. For other types of subpart F income, the high-tax exception applies to CFCs' income earned at a foreign effective tax rate that is 100 percent of the maximum US rate.

The Draft does not apply FBCSI treatment to the income of CFCs located in countries with a comprehensive US tax treaty. The Draft also departs from its 2011 predecessor in providing an inflation adjustment for the foreign base company income *de minimis* exception and in retaining both Sections 956 (CFC investments in US property) and 959 (previously taxed income).

Observation: Making CFC look-through permanent will stabilize many global intercompany arrangements. The lower US corporate tax rate should expose fewer CFCs to subpart F income treatment under the mandatory high-tax exception, but in conjunction with the proposed FBCII rules, the exception also could be seen as effectively creating a minimum tax regime on a substantial portion of CFC income.

In the area of sourcing, expense allocation, and FTC mechanics, the Draft proposes some major modifications to the Code that differ from the 2011 document's changes. The Draft keeps the approach of multiple FTC limitation baskets, replacing the passive income category with a 'mobile income' category by specifically adding FBCSI and FBCII to that category. In addition, the Draft eliminates 50/50 sourcing for US-produced goods sold to foreign customers. The new rule takes only production activities into account in sourcing such sales. Also unlike its 2011 predecessor, the Draft does not eliminate Section 909 and the concept of FTC splitting events. The Draft does not provide transition rules for FTC carryovers from current law to the proposed regime.

Observation: The changes just discussed are not generally favorable to taxpayers. However, under the proposed territorial regime, FTCs would not be as important as they are under current law. Placing intangible income and FBCSI in the passive basket likely will limit cross-crediting opportunities for significant categories of active business income. Eliminating the Section 863(b) inventory sourcing rule will reduce opportunities for some US manufacturers to benefit from the FTC regime.

The Draft includes some FTC-related proposals previously included in the 2011 document. It eliminates Section 902 deemed-paid FTCs and applies Section 960 FTCs for subpart F inclusions on a current-year basis. It also allocates only 'directly allocable deductions' to reduce foreign-source income for FTC limitation purposes. The Draft does not change the FTC carryover rules.

Thin capitalization rules

Like its 2011 predecessor document, the Draft imposes 'thin capitalization'

rules denying interest expense deductions of US shareholders in worldwide affiliated groups with ‘excess domestic indebtedness.’ However, this proposal differs from the 2011 version in the specific percentages used for the two tests of debt levels: a 110-percent US-to-worldwide debt ratio (raised from the 100-percent ratio in 2011) and 40 percent of adjusted taxable income (ATI) (a figure left open in 2011).

Observation: The Draft liberalizes the 2011 thin cap proposal by providing a more favorable ratio for US debt compared to worldwide debt in a worldwide affiliated group.

Other new proposals

Other notable new international tax proposals in the Draft include:

- Adopting the Administration’s proposal limiting certain deductions for reinsurance premiums.
- Reducing the Section 163(j) earnings-stripping threshold from 50 percent to 40 percent of ATI, conforming to the proposed thin capitalization rule.
- Changing the sourcing of foreign persons’ income for passenger cruises in US waters.
- Limiting the PFIC insurance exception.
- Limiting treaty benefits for certain US payments through foreign intermediate entities.

Merger and acquisition transactions

The Draft does not contain any major changes to the current tax treatment of corporations or shareholders who engage in merger and acquisition (M&A) transactions. However, it does contain several significant proposals that could affect such transactions.

The Draft includes a proposal that would prevent tax-free spinoffs under Section 355 involving real estate investment trusts (REITs) by (1) making a REIT ineligible to satisfy the active trade or business test and (2) prohibiting a C corporation that participates in a spinoff from electing REIT status for ten years following the spinoff.

Other corporate M&A proposals include the following:

- The Draft precludes a loss importation result when built-in loss property is sold in a related-party sale, by ‘turning off’ Section 267(d) with respect to a transferee when the property that is later sold or exchanged was not subject to US federal income tax in the hands of the transferor immediately before the transfer but post-transfer gain or loss with respect to the property is subject to US federal income tax.
- The Draft repeals the Section 279 corporate interest deduction for interest in excess of \$5 million on corporate acquisition indebtedness, generally defined as debt under certain limited subordinated obligations issued as consideration for a stock or asset acquisition.
- The Draft requires recognition of built-in gain on assets when a C corporation converts or transfers assets in a carryover basis transaction to a REIT or RIC and repeals the option to treat the transaction under Section 1374.

Partnerships

The Draft incorporates several proposals which were previously included in Chairman Camp’s March 2013 small business tax reform proposals. For more on the earlier

discussion draft affecting partnerships, see the March 12 [WNTS Insight](#).

Carried interest

The Draft’s carried interest proposal adopts a new approach for determining the amount of capital gain to recharacterize as ordinary income with respect to a partnership interest provided to a partner in connection with the performance of services by the partner. The proposal only applies to service providers of a partnership that is engaged in a trade or business of (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses. The proposal does not apply to a partnership engaged in a real property trade or business.

Generally, the proposal recharacterizes a service partner’s applicable share of the partnership’s invested capital (generally determined based on the partner’s maximum share of profits) as generating ordinary income equal to the product of that share and a specified rate of return (the Federal long-term rate plus 10 percentage points). This formula is intended to be a proxy for the amount of compensation earned by the service partner for managing the capital of the partnership (i.e., the amount of income that is potentially subject to recharacterization). The amount would be determined (but not realized) on an annual basis and tracked over time.

By capping the amount of income that may be recharacterized, the Draft limits the recharacterization of income to the “deemed compensation” earned for managing the capital of the partnership. Thus, to the extent the service partner has gains in excess of such amount, the excess is still taxed as capital gains.

Self-employment tax

The Draft conforms the treatment of earnings passed through to materially participating general partners, limited partners, limited liability company members, and S corporation shareholders for purposes of imposition of SECA taxes. In general, the Draft requires partners and S corporation shareholders that materially participate in the activities of their “flow through” entity to treat 70 percent of their share of non-separately stated income and compensation as net earnings from self-employment. Non-materially participating partners or S corporation shareholders would not be subject to SECA on their share of earnings. The definition of material participation is the same as that for the passive activity rules found in Section 469(h).

In addition, the draft includes the following partnership proposals:

- Rules relating to guaranteed payments are repealed. Payments by a partnership to a partner are treated either as a payment to a partner not acting in its capacity as a partner or as a distribution of partnership income or capital.
- Mandatory adjustments of a partnership’s basis in partnership property are required upon a transfer of a partner’s interest or when the partnership distributes property to a partner. The proposal applies to securitization partnerships and electing investment partnerships.
- Charitable contributions and foreign taxes paid must be taken into account in calculating the limitation on the partner’s share of losses.
- Revisions related to unrealized receivables and inventory items:

- Any distribution of inventory is treated as a sale or exchange (eliminates the “substantial appreciation” requirement).
- Unrealized receivables include any property other than inventory (to the extent of the amount that would be treated as ordinary income if the property were sold for its fair market value).

The time limitation on taxing precontribution gain is repealed. A partner who contributes property with pre-contribution built-in gain or loss to a partnership must recognize gain or loss when the partnership distributes the property, or the partner receives other property in exchange for their interest.

Technical termination rules are repealed. A partnership is treated as continuing if more than 50 percent of the interests of the partnership are sold or exchanged and new elections would not be required or permitted.

The publicly traded partnership exception is restricted to mining and natural resource partnerships. All other publicly traded partnerships generally are treated as C corporations.

Repeal of the TEFRA and electing large partnership rules

The partnership audit rules are replaced with a single set of rules for auditing partnerships and their partners at the partnership level. Partnerships with 100 or fewer partners could opt out of the new rule and be audited under the general rules for individual taxpayers. Any adjustments would be taken into account by the partnership in the year that the audit is completed.

S corporation proposals

In general, the Draft makes it easier to elect or maintain S corporation status. The Draft also makes permanent two expired provisions:

- the reduction of the recognition period for the assessment of built-in gains tax from 10 years to 5 years, effective for tax years beginning after 2013, and
- limiting basis adjustments for the contribution of appreciated property by an S corporation to the basis of the property contributed to the charity.

In order to expand the availability of electing S corporation status, the Draft permits nonresident alien individuals to be potential current beneficiaries of an Electing Small Business Trust (effective January 1, 2015). Effective for tax years beginning after 2014, the Draft increases the excess passive income threshold from 25 percent of gross receipts to 60 percent of gross receipts before the excess passive income tax (also known as the “sting tax”) is imposed on an S corporation. In addition, the Draft repeals the provision that causes an S election to terminate as a result of having excess passive income.

The Draft conforms the rules for an Electing Small Business Trust to deduct charitable contributions to those applicable to individuals; this provision imposes a percentage limitation but also allows for carryforwards of excess contributions effective for tax years beginning after 2014.

For tax years beginning after 2014, the Draft extends the due date for making S corporation and qualified Subchapter S subsidiary elections to the due date of the return (including extensions) for which the election is desired. In addition, the Draft

removes the ability to retroactively elect Qualified Subchapter S Trust status.

Financial Products

Mark-to-market of derivatives

Under the Draft, investors and traders must mark-to-market all "derivatives" (broadly defined) in their portfolio on an annual basis. Any income resulting from the deemed disposition would be ordinary (not capital gain). Likewise, any losses would be ordinary, and generally deductible without restriction. The Draft repeals the 60-percent long term/40-percent short term capital gain treatment generally afforded to futures contracts and other Section 1256 contracts.

In addition, if a derivative substantially diminishes risk with respect to a publicly traded nonderivative position that is held by the taxpayer (i.e., if a derivative "straddles" an actively traded nonderivative), built-in gain on the nonderivative is recognized immediately. This gain on the nonderivative would be capital gain. Built-in loss, however, is not recognized by reason of the mark-to-market regime, but is suspended until the position is disposed of, retaining its capital loss character. Thereafter, for so long as the derivative and nonderivative are held together as a "straddle," both positions (including the nonderivative) would be marked-to-market on an annual basis (each generating ordinary income/loss). As under current law, the holding period of the nonderivative would be suspended while it is part of a straddle.

The Draft provisions generally are the same as mark-to-market proposal in the Chairman Camp's January 2013 financial products discussion draft, with the following clarifications:

- Stocks or bonds are not derivatives, and are subject to the mark-to-market regime only if held as a position that is part of a "straddle" that includes a derivative.
- A derivative includes a contract with an embedded derivative component. The Draft explains that where an embedded derivative component cannot be separately valued, the entire contract is treated as a derivative.

For more on Chairman Camp's earlier financial products discussion draft, see the February 12, 2013 [WNTS Insight](#).

Hedging

To simplify the tax hedge identification requirement, the Draft effectively deems a tax hedge identification to have been made in situations where the transaction is properly treated as a hedging transaction in a taxpayer's audited GAAP financial statements.

The Draft expands the definition of a hedging transaction to include a transaction entered to manage the risk of price changes or currency fluctuations with respect to indebtedness held by an insurance company.

Rules governing "distressed debt"

In situations in which debt is modified or exchanged with the original issuer after December 31, 2014 (thereby triggering a taxable exchange), the proposal amends some highly technical rules to ensure that the debt issuer does not have "cancellation of indebtedness" income if no principal is forgiven.

The Draft also provides that holders of the existing obligation do not recognize gain or loss in a debt-for-debt exchange with the same issuer, except to the extent the holder also

receives money or property (in addition to the new debt instrument) in the exchange.

Current inclusion of market discount

Taxpayers who acquire a market discount bond after December 31, 2014, must accrue market discount into income on a current basis. In situations where the issuer of the bond is distressed, this accrual would be limited. (The proposal provides a precise numerical test to determine when this limitation applies.)

This proposal in the Draft generally is the same as Chairman Camp's 2013 draft proposal with certain clarifications, the most important of which is that loss realized upon the disposition of a market discount bond is treated as ordinary loss to the extent of any market discount previously included in income.

Mandatory use of FIFO accounting of securities

Under the Draft, a taxpayer no longer can specifically identify the securities that it sells for purposes of determining its cost basis. Instead, cost basis of any security sold after January 1, 2015, must be computed under a 'first-in/first-out' methodology. This is a change from the 2013 proposal that would have required the use of an 'average cost' method as the single method of determining basis in sold securities.

Other proposals in the Draft regarding the taxation of financial products include:

- Convertible debt instruments are taxed under the contingent payment bond method of current Treasury regulations.
- Section 451 general recognition principles apply to certain payments received on pools of debt instruments.

- Wash sale rules are expanded to apply to situations in which a taxpayer sells a security at a loss and the security is reacquired by a related party.
- The application of Section 1032 is limited with respect to certain forward contracts giving rise to income treated as “in the nature of interest income.”

Financial institutions

Excise tax on systemically important financial institutions

The Draft imposes a new excise tax on certain large financial institutions that are considered systemically important financial institutions (SIFIs) under the Dodd-Frank Wall Street Reform and Consumer Protection Act. SIFIs are defined, in part, as bank holding companies with at least \$50 billion in total consolidated assets and non-bank financial institutions designated for SIFI treatment by the Financial Stability Oversight Council.

Under the proposal, a SIFI must pay a quarterly excise tax of 0.035 percent of its total consolidated assets in excess of \$500 billion (indexed for increases in GDP), beginning in 2015. According to a Ways and Means summary of the Draft, the excise tax, which the JCT estimates would raise \$86.4 billion over 10 years, is intended to recoup part of the implicit subsidy from which the largest financial institutions are perceived to benefit due to their SIFI designation.

Limitation on deduction for FDIC premiums

Under the draft, amounts paid by certain large financial institutions pursuant to an assessment by the Federal Depositary Insurance Corporation (FDIC) no longer are deductible as a trade or business expense. Assessments for institutions with total consolidated assets greater

than \$50 billion would be completely nondeductible and a percentage of the assessment would be nondeductible for institutions with total consolidated assets between \$10 billion and \$50 billion.

Insurance

The Draft generally does not change the current-law tax treatment of individuals who purchase life insurance; however, it curtails benefits of some corporate purchasers of life insurance. The Draft also changes a number of provisions that affect insurance companies. The insurance provisions are targeted at achieving what the House Ways and Means executive summary describes as a “much-needed balance” between subjecting insurance companies to the same rules as other businesses and preserving the safety net that this industry provides.

The insurance proposals contained in the Draft include changes in the interest rate used to calculate life insurance reserves and in the discounting methodology used to compute property and casualty reserves. Additionally, the rates used to capitalize policy acquisition expenses (DAC) would significantly increase.

The Draft also modifies the proration rules for both life and property and casualty companies. For life insurance companies, the dividends-received deduction is computed using a new formula based on a company's total assets and total reserves, resulting in a significantly lower deduction than under current law. For property and casualty companies, the fixed 15-percent reduction in the reserve deduction for property and casualty companies is replaced by a formula whereby the reserve deduction is reduced by a percentage equal to the ratio of the tax-exempt assets to all the assets of the company.

Other insurance proposals include the following:

- Exception to pro rata interest expense disallowance for corporate-owned life insurance restricted to 20-percent owners and not officers, directors, or employees
- Change in NOL rules for life insurance companies to mirror the rules used by other industries (i.e., back two years, forward 20 years)
- Repeal of small life insurance company deduction
- Change in rules for changes in basis for computing life insurance reserves
- Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus account
- Repeal of special treatment of Blue Cross and Blue Shield organizations, etc.
- Repeal of special estimated tax payments
- Tax reporting requirements for certain life settlement transactions
- Clarification of tax basis of life insurance contracts
- Limitation to the exception to transfer for valuable consideration rules

Tax administration and compliance

The proposals contained in this section of the Draft fall into four main categories: (1) reforms to address problems that have been identified during the course of the Ways and Means Committee's investigation of certain IRS issues; (2) reforms intended to enhance taxpayer

protection and service; (3) simplification of tax return due dates; and (4) compliance reforms.

According to the House Ways and Means executive summary, these reforms are designed to “make the IRS accountable to the taxpayer, protect taxpayers’ identities and end agency mismanagement.”

The Draft’s provisions aimed at investigation-related reforms address the process and the manner in which the IRS reviews organizations intending to operate as social welfare organizations. The Draft proposes a streamlined notification process for 501(c)(4) organizations, a clarification of the applicable standards used to determine 501(c)(4) status, an extension of judicial declaratory judgment relief to controversies involving the initial or continuing qualification of 501(c)(4) organizations, a reduction of the types of donor information required to be disclosed to the IRS, and mandatory electronic filing of all Forms 990.

As measures intended to “enhance taxpayer rights,” the Draft includes an expansion of the Commissioner’s duties, an expansion of the acts or omissions that result in the mandatory termination of an IRS employee, the imposition of a mandatory review of IRS examination selection procedures by the Office of the Comptroller General, and a moratorium on IRS training and management conferences.

Specific measures in the Draft aimed at enhancing taxpayer protection and service focus mainly on the prevention of tax identity theft through the use of truncated Social Security numbers, continued efforts to expand and promote the use of electronic filing, and an increased refund and credit threshold from \$2 million to \$5 million for Joint Committee on Taxation review.

The Draft also proposes simplification of certain tax returns and the modification of the schedule for filing returns, requiring flow-through entities, such as partnerships and S corporations to file by March 15 (or two and a half months after the close of its taxable year) and extending the deadline for C corporations to April 15 (or three and a half months after the close of its taxable year). Several of these measures are similar to those proposed in a November 2013 Senate Finance Committee staff discussion draft on tax administration, including proposals for increased authority to utilize truncated Social Security numbers, expansion of the credit threshold for JCT review, and modification of certain filing due dates.

For more on the Finance Committee staff tax administration discussion draft, see the November 20, 2013 [*WNTS Insight*](#).

To increase taxpayer compliance, the Draft makes certain changes to the present penalty regime, including increasing certain existing penalties, and provides the IRS with various enhanced collection mechanisms, through the use of private debt collectors and levy authorization of up to 100 percent of a payment to a Medicare provider. The Draft also provides a “clarification” of the six-year statute of limitations to apply to a return on which a taxpayer claims an adjusted basis for any property that creates a substantial omission of income on the return.

Worker classification

Under current law, the determination of whether a worker is an employee or independent contractor is determined under a common-law test in light of all the facts and circumstances. If certain conditions are met, the Draft provides a safe harbor for individuals who would otherwise be classified as employees under the common law

test. If the IRS determines that the conditions of the safe harbor are not met, an IRS determination that the individual is an employee under common law will have only prospective effect. Where the safe harbor conditions are met, the Draft includes income tax withholding from the first \$10,000 of compensation paid to the service provider.

Excise taxes

The Draft repeals the medical device excise tax for sales occurring after the date of enactment of the legislation. The medical device excise tax was enacted by the Health Care and Education Reconciliation Act of 2010 in conjunction with the Patient Protection and Affordable Care Act, and generally, imposes an excise tax on the sale, lease or use of certain medical devices by the manufacturer, producer, or importer of the device in an amount equal to 2.3 percent of the sale price.

The Draft makes changes to the Oil Spill Liability Tax imposed by Section 4611. First, the Draft extends the Oil Spill Liability Trust Fund financing rate (currently eight cents per barrel and increasing after December 31, 2016 to nine cents per barrel) to December 31, 2023. Second, the Draft extends the tax to oil derived from tar sands, oil sands, shale oil, and oil shale. Finally, the Draft removes the requirement that domestic crude oil be produced from a well.

The Draft raises the Inland Waterways Trust Fund financing rate for fuel used after December 31, 2014, from 20 cents to 26 cents per gallon.

The Draft expands the exclusion for orphan drug sales from the computation of branded prescription drug sales in determining the annual branded prescription drug fee.

The Draft repeals a number of fuel-related credits (Sections 40, 40A, and

6426), including credits for alcohol fuel, alcohol fuel mixtures, small ethanol producers, second generation biofuel producers, biodiesel, biodiesel mixtures, renewable diesel and renewable diesel mixtures, small agri-biodiesel producers, alternative fuels, and alternative fuel mixtures. Many of these credits expired on or before December 31, 2013.

Oil and gas proposals

The Draft would repeal the following oil and gas provisions:

- Percentage depletion cost recovery method applicable to oil and gas property
- Passive activity exception for working interests in oil and gas property
- Recurring item exception for oil or gas well tax shelters
- Enhanced oil recovery credit
- Credit for producing oil and gas from marginal wells
- Expired election to expense certain refineries

Other energy proposals

The Draft reduces the amount of the Section 45 production tax credit (PTC) by eliminating the inflation adjustment that exists in the current credit, resulting in the credit being limited to a maximum of 1.5¢ per kw/hr. of electricity generated. The change applies to electricity produced after December 31, 2014, which would have the effect of reducing tax benefits for both existing projects and those that met the PTC “begun construction” test by the end of 2013. The PTC would expire on December 31, 2024.

The Draft requires a “program of continuous construction” in order to meet the PTC begun construction test.

The Draft also eliminates the Section 48 energy investment tax credit (ITC) but allows taxpayers to claim the

credit for property placed in service on or before December 31, 2016, the currently scheduled expiration date for the full 30-percent ITC.

Finally, the Draft repeals numerous other existing and expired provisions for renewable energy, energy efficient property, alternative fuels and vehicles, carbon capture and sequestration, and others.

These repealed provisions include:

- The Section 30C credit for alternative fuel vehicle refueling property
- The Section 30D credit for plug-in electric vehicles
- The Section 45L credit for energy-efficient homes
- The Section 45M credit for energy-efficient appliances
- The Section 45Q credit for carbon dioxide sequestration
- The Section 48A credit for advanced coal projects
- The Section 48B credit for qualifying gasification projects
- The Section 48C credit for qualifying advanced energy projects
- The Section 179D deduction for energy-efficient commercial buildings

Individual tax reform proposals

Tax rates

Individual tax rates under the Draft are compressed to three brackets – 10, 25, and 35 percent – with the 35-percent rate applying to a more broadly defined Modified Adjusted Gross Income (MAGI). For 2015, the 10-percent rate would cover income up to \$71,199; the 25-percent rate would cover income from \$71,200 up to \$450,000 (for married taxpayers)

and \$400,000 (for all other taxpayers).

MAGI – income subject to the 35-percent rate and used to determine the phaseout of the 10-percent bracket – includes all income otherwise taxable at 10 percent and 25 percent plus income excluded as foreign earned income, tax-exempt interest, employer-sponsored health insurance payments, self-employed health insurance deduction, pre-tax contributions to defined contribution retirement plans, medical savings accounts deductions, income excluded as apportioned to US Territories, and excluded social security or railroad Tier I benefits. Also, itemized deductions other than the deduction for charitable contributions can be taken only against the 25-percent bracket, but not the 35-percent bracket.

Qualified domestic manufacturing income, similar to qualified production activity income under current law Section 199, is excluded in computing MAGI. As a result, the qualified manufacturing income of individuals, including individuals who are partners and shareholders of pass-through entities, would be taxed at the same 25-percent rate as corporations.

The 10-percent rate is phased out for taxpayers with MAGI over \$300,000 for married taxpayers and \$250,000 for all others.

The tax rate changes apply also to trusts and estates. However, only the 25-percent and 35-percent rates are applicable. The threshold for the 35-percent rate is \$12,000.

All rate brackets are indexed for inflation using a ‘chained CPI’ inflation index beginning in 2015; this measure of inflation increases more slowly than the current CPI index.

Exceptions previously provided to certain foreign individuals lawfully

working in the United States are eliminated, as well as for student employees of colleges, schools, or universities. The Draft also reverses Treasury guidance exempting certain unemployment benefits from the definition of wages, thereby subjecting such payments to FICA, RRTA, and FUTA.

The Draft repeals the individual AMT.

Investment income

The Draft eliminates the preferential tax rate for long-term capital gains and qualified dividends and subjects such income to the three new rate brackets. Non-corporate taxpayers can claim an above-the-line deduction equal to 40 percent of adjusted net capital gain, defined as the sum of net capital gains and qualified dividends, reduced by net collectible gains.

The Draft continues the exclusion of gain on the sale of a principal residence, but increases the required holding period to five of the last eight years, and phases out the exclusion at certain MAGI levels. Finally, the Draft establishes a new requirement that provides for basis consistency. Property received from a decedent has a maximum basis equal to the fair market value of the asset as reported on the decedent's Form 706.

Note: The Draft does not propose repeal of the 3.8-percent Net Investment Income tax enacted as part of the Affordable Care Act.

Deductions

The Draft proposes to limit or repeal many current-law deductions.

The provisions include an increased basic standard deduction to \$22,000 for married taxpayers and \$11,000 for all other taxpayers. The basic standard deduction is phased out for taxpayers with MAGI over \$513,600 (married) and \$356,800 (all others).

The Draft eliminates the deductions for personal exemptions.

Mortgage interest

The Draft allows mortgage interest deduction limits to be computed for existing loans under the current-law \$1 million cap, but provides a phased-in reduced loan limit for all mortgages entered into after December 31, 2014. The loan limit would be reduced as follows:

- 2015: \$875,000
- 2016: \$750,000
- 2017: \$625,000
- 2018 and beyond: \$500,000

The deduction for interest associated with home equity indebtedness is eliminated.

Investment interest

Under the Draft, the amount otherwise allowed as an individual deduction for investment interest for a taxable year is reduced by the amount of tax-exempt interest received by the taxpayer during the year.

Charitable deduction

Under the Draft, the charitable deduction is available for individuals only to the extent the total contributions exceed two percent of the individual's contribution base. The Draft reduces the 50-percent and 30-percent limitations applicable to individuals under present law to 40 percent and 25 percent, respectively, and eliminates the lower percentage limits for contributions to certain private foundations. The Draft allows an individual donor to deduct contributions made up to the April 15 tax return filing due date.

Contributions of appreciated property are limited to basis, except in cases involving publicly traded stock, qualified conservation contributions, contributions of inventory and

scientific property eligible for an enhanced deduction under present law, and tangible personal property used by the donee for exempt purposes, in which cases the deduction would be fair market value reduced by short-term capital gain and ordinary income. The Draft eliminates the 80-percent deduction rule for college athletic event seating rights, the special deduction rules for intellectual property donations, and the deduction for contributions of golf course conservation easements.

Credits and other deductions

Under current law, there are approximately 15 different credits and deductions aimed at education. The Draft consolidates or eliminates all education benefits to the following five:

- Permanent American Opportunity Tax Credit – Replaces Hope credit, lifetime learning credit, tuition deduction, and temporary AOTC
 - 100 percent of first \$2,000 qualified tuition and related expenses
 - 25 percent of next \$2,000 qualified tuition and related expenses
 - Maximum credit - \$2,500
 - Phased out at AGI of \$86,000-\$126,000 MFJ/\$43,000-\$63,000 all others
- Deduction for work-related education expenses – no change
- Exclusion of scholarships and grants – expanded Pell Grant
- Gift tax exclusion for tuition payments – no change
- Tax-free 529 savings plan – no change

The Draft expands the Child Tax Credit to cover children and other dependents, indexes the credit for inflation, and makes reporting the child/dependent social security number on the tax return mandatory for the credit. The Draft disallows the refundable credit for any year a taxpayer claims an exclusion of income under Section 911 (foreign earned income). Similar to the basic standard deduction, this credit is phased out for taxpayers with MAGI over \$623,600 (married) and \$411,800 (all others).

In an effort to simplify the code, this Draft eliminates numerous credits and deductions, as follows:

- Education provisions repealed
 - US Savings Bond exclusion
 - Student loan interest deduction
 - Qualified tuition and expenses deduction
 - No new Coverdell contributions
 - Exclusion of discharge of student loan indebtedness
 - Qualified tuition reduction exclusion
 - Exclusion for education assistance programs
 - Exception to 10 percent penalty for early withdrawals from retirement plans for education
- Credits repealed
 - Dependent care credit
 - Adoption credit
 - Nonbusiness energy property credit
 - Residential energy efficiency credit

- Alternative fuels vehicle credit
- Health insurance credit
- First-time homebuyer credit
- Deduction for unreimbursed employee expenses – repealed
- Itemized deduction for taxes not incurred in a trade or business – repealed
- Personal casualty loss deduction – repealed
- Losses from wagering – deductible only to the extent of gains in the current tax year
- Deduction for tax preparation fees – repealed
- Medical expenses deduction – repealed
- Deduction for alimony payments/inclusion of income – repealed
- Moving expenses deduction – repealed
- Deduction for medical savings accounts – repealed
- 2-percent floor on miscellaneous itemized deductions – repealed
- 3 percent of AGI overall limitation on itemized deductions ('Pease limitation') – repealed
- Exclusion for employee achievement awards – repealed
- Fringe benefits exclusions (no-additional cost services, qualified employee discounts, use of aircraft by parent of employee) – repealed
- Exclusion for net unrealized appreciation in employer securities - repealed

Other significant proposals include:

- Eliminating the exemption provided to nonresident aliens (foreign persons subject to US tax) for income earned on passenger cruise ships within US territorial waters;
- Limiting the benefits of treaty provisions that reduce the 30-percent withholding tax on FDAP (Fixed, Determinable, Annual or Periodic) income when deductible payments are made between members of the same group controlled by a foreign parent;
- For purposes of the foreign tax credit, the passive category of income and deduction is relabeled "mobile" and expanded to include related-party sales income, foreign intangible income, as well as current-law passive income.

Retirement and benefits tax reform proposals

Retirement benefits

The Draft reduces by half the existing limits on employee pre-tax contributions to 401(k) plans, with the remaining half eligible to be contributed on an after-tax basis to a Roth account. This proposal also applies to 403(b) and 457 plans. For example, for 2014, the limit on elective deferrals is \$17,500, with an additional \$5,500 available to employees age 50 and older as a catch-up contribution for a total of \$23,000. Under the Draft, any contributions in excess of half of those limits (\$8,750 and \$11,500 respectively) would be to a Roth account. Employers with more than 100 employees must offer Roth accounts in their plans.

Observation: According to the Ways and Means section-by-section summary, this provision is intended to help Americans achieve greater retirement security by making more

savings income available to them at retirement, since unlike previously taxed amounts, Roth benefits are not taxed upon receipt.

The Draft also defers indexing of the limits that apply to retirement plans to 2024, when indexing based on chained CPI would commence, starting from the limit in effect in 2023 (the 2014 dollar amount). This would apply to the overall limits on defined benefit and defined contribution plans as well as to the limits on elective deferrals, Roth IRA contributions, and contributions to other plans.

Additional retirement proposals in the Draft include:

- Repeal of the exception to the 10-percent penalty on early withdrawals from IRAs and retirement plans for education expenses and for first-time home purchases, and application of this tax to distributions from governmental 457 plans
- Change the distribution rules for IRAs and qualified plans, to
 - eliminate the exclusion of net unrealized appreciation in employer securities
 - modify the required minimum distribution rules for certain beneficiaries (the ‘stretch IRA’ provision)
 - permit defined benefit plans to make in-service distributions starting at age 59½
 - eliminate required suspension of contributions following a hardship distribution, and
 - extend the period for rollover of a plan loan following termination of service

- Elimination of the income limits on contributions to after-tax Roth IRAs, prohibition on new pre-tax and nondeductible contributions to traditional IRAs, and repeal of the ability to recharacterize Roth contributions as traditional IRA contributions
- Elimination of certain retirement vehicles for small employers, including SEP and SIMPLE 401(k) plans
- Elimination of special catch-up contribution rules under 403(b) and governmental 457 plans, to make the limits for those plans identical to the new limits on 401(k) plans
- Repeal of the credit for small employer pension plan startup costs

Other benefits provisions

The Draft reinstates the rule making certain expenses for over-the-counter drugs eligible for reimbursement under flexible spending accounts (FSAs) and health savings accounts (HSAs). In addition, the Draft proposals include:

- Repeal of the deduction for medical expenses and long-term care insurance premiums
- Elimination of the deduction and exclusions for contributions to medical savings accounts
- Repeal of the small-employer health insurance credit
- Repeal of the exclusion for educational assistance programs, and
- Repeal of the employer-provided child-care credit.

Nonqualified deferred compensation limits

Current law imposes rules on when an employee can defer compensation and when the deferred compensation can be paid. If these rules are met, the employee is taxed when the compensation is paid and the employer claims a deduction at that time.

Under the Draft, employees, directors, and certain independent contractors are taxed on compensation as soon as there is no service-based substantial risk of forfeiture with regard to that compensation (i.e., receipt of the compensation is not subject to future performance of substantial services). The proposal applies to all nonqualified deferred compensation, including stock options and stock appreciation rights, and is effective for amounts attributable to services performed after 2014.

The Draft also

- Replaces the rules for deferred compensation for taxable, tax-exempt, and nonqualified entities and subjects all programs to one set of rules.
- Provides that amounts that are earned through 2014 could remain under current programs until 2022, at which point those arrangements would be subject to the new rules.

Deduction for executive remuneration

Under current law, a corporation generally may deduct compensation expenses as an ordinary and necessary business expense. The deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation, however, is limited to no more than \$1 million per year. For these purposes, a covered employee is defined as the chief executive officer and the three

named executive officers whose compensation is reported on the annual proxy report but not the chief financial officer. The limits do not apply to compensation paid after the covered employee separates from service. There is an exclusion from the \$1 million limit for qualified performance-based compensation and commissions.

The Draft repeals the exception to the \$1 million limit for commissions and performance-based compensation effective for tax years after 2014.

The Draft also

- Revises the definition of covered employee to mirror the SEC disclosure provisions, thus adding back the CFO.
- Provides that once an employee qualifies as a covered person, the deduction limitation applies for Federal tax purposes to that person so long as the corporation pays remuneration to such person (or to any beneficiaries), even following retirement.

Employee fringe benefits

The Draft limits or eliminates the tax exclusion for several employer-provided fringe benefits, including:

- Repeal of the exclusion for education assistance programs, currently \$2,500 per year.
- Repeal of the exclusion for employee achievement awards that are given in recognition of the employee's length of service or safety achievement, and repeals the restrictions on employer deductions for such awards.
- Limiting qualified transportation fringe benefits to 2014 limits with no indexing for inflation and

eliminating the qualified bicycle commuting reimbursement.

Observation: The Draft does not provide for 'mass transit parity'; the exclusion for transportation benefits would continue to be \$250 per year for parking and \$130 per year for transit benefits.

Under current law, an employee generally can claim expenses relating to the trade or business of being an employee only as an itemized deduction, with certain exceptions. Under the Draft, the itemized deduction would be repealed, and the only above-the-line deductions allowed for expenses attributable to the trade or business of being an employee would be those for reimbursed expenses and certain expenses of members of reserve components of the United States military.

Exempt organizations

The Draft contains numerous proposals affecting tax exemption standards for certain organizations, the determination of unrelated business income, excise taxes, and the charitable deductions (discussed above). The Draft imposes a new entity-level excise tax on excess compensation paid by exempt organizations, and requires that all Form 990 series returns be e-filed.

Modifications to exempt status

The Draft repeals exempt status for professional sports leagues, small insurance companies, and health insurance co-ops, and limits the exemption for certain state workers' compensation funds to those offering only in-state insurance. The draft also repeals Type II and Type III supporting organizations.

Unrelated business income (UBI) tax

The Draft treats as UBI amounts derived from (1) the sale or licensing

of an exempt organization's name or logo, (2) corporate sponsorship payments if the exempt organization uses or acknowledges the corporate sponsor's product lines, (3) fundraising event corporate sponsorship income greater than \$25,000 from the event unless the use or acknowledgment of the sponsor's name or logo only appears with and in the same manner as the names of a significant portion of the event's other donors, and (4) fundamental research unless the research results are freely available to the general public. The Draft requires the determination of UBI separately with respect to each unrelated trade or business, and prohibits the use of a loss from one trade or business to offset the income from another. The Draft increases the specific deduction against UBI from \$1,000 to \$10,000.

Excise taxes on net investment income

The Draft imposes a one-percent excise tax on the net investment income of private colleges and universities with endowment assets of at least \$100,000 per full-time student. The excise tax on net investment income of private foundations is reduced to a flat one-percent tax.

Other exempt organizations proposals:

- Impose a 2.5 percent entity-level excise tax (10 percent in the case of excess compensation) on private foundations involved in an act of self-dealing.
- Impose a 25-percent excise tax on exempt organizations that pay excessive compensation or make an excess parachute payment to a covered employee.

- Limit the FICA exemption for students of schools, colleges, and universities.

Joint Committee on Taxation (JCT) revenue and economic growth estimates

The JCT provided two sets of estimates of the impact of Chairman Camp's tax reform discussion draft on the federal budget.

The first set is consistent with the budget rules used to evaluate the deficit impact of legislation. Often referred to as "static" scoring, these estimates include behavioral responses by taxpayers but assume the package would not impact the overall size of the economy. Under these assumptions, the package is estimated to increase revenues by \$3 billion over the 2014 to 2023 fiscal year period.

These estimates do not incorporate the impact of the reform package on future economic growth. The reform proposal would lower statutory tax

rates on household labor earnings. As a result, JCT believes that individuals would have an increased incentive to work and provide more labor to the economy. The decreased tax burden experienced by households would increase their after-tax income, increasing their demand for goods and services, according to the JCT. Both of these impacts increase the size of the economy, which would lead to additional tax revenues on the new economic activity.

For businesses, JCT estimates that the base-broadening measures in the tax reform package would more than offset the lower statutory rate on business income and, on net, decrease the after-tax return to business capital.

Estimating the overall impact of these "dynamic" impacts is challenging because different modeling approaches and assumptions can yield different results. JCT prepared estimates using two separate macroeconomic models with separate

assumptions on the responsiveness of households and businesses to changes in tax incentives.

The reform package is estimated by JCT to increase the size of the economy by between 0.1 percent and 1.6 percent over the 2014 to 2023 period. As a result, federal government revenues are estimated to increase by between \$50 billion and \$700 billion relative to the conventional revenue estimate.

The takeaway

The release of draft tax reform legislation by Chairman Camp represents a significant step in presenting a possible path for reducing corporate and individual tax rates, reforming US international tax rules, and simplifying the tax code.

Stakeholders should evaluate the proposals and provide the Ways and Means Committee with feedback on Chairman Camp's tax reform draft.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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For more information

- [House Ways and Means Committee executive summary](#)
- [House Ways and Means Committee statutory language](#)
- [House Ways and Means section-by-section report](#)
- [Joint Committee on Taxation materials](#)

For additional insights, please join PwC on March 10 at 12:30pm for a webcast covering the discussion draft.

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