

**TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014,
A DISCUSSION DRAFT OF THE CHAIRMAN OF
THE HOUSE COMMITTEE ON WAYS AND MEANS
TO REFORM THE INTERNAL REVENUE CODE:
TITLE I – TAX REFORM FOR INDIVIDUALS**

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CONTENTS

	<u>Page</u>
INTRODUCTION	1
TITLE I – TAX REFORM FOR INDIVIDUALS.....	2
A. Individual Income Tax Base Reform.....	2
1. Simplification of individual income tax rates (secs. 1001 and 1003 of the discussion draft and secs. 1 and 2 of the Code).....	2
2. Deduction for capital gains and dividends of individuals (sec. 1002 of the discussion draft and sec. 169 of the Code)	10
B. Simplification of Tax Benefits for Families	13
1. Standard deduction (sec. 1101 of the discussion draft and sec. 63 of the Code).....	13
2. Increase and expansion of child tax credit (sec. 1102 of the discussion draft and sec. 24 of the Code).....	14
3. Modification of earned income tax credit (sec. 1103 of the discussion draft and sec. 32 of the Code).....	16
4. Repeal of deduction for personal exemptions (sec. 1104 of the discussion draft and sec. 151 of the Code).....	20
C. Simplification of Education Benefits.....	23
1. American Opportunity Tax credit (sec. 1201 of the discussion draft and sec. 25A of the Code).....	23
2. Expansion of Pell grant exclusion from gross income (sec. 1202 of the discussion draft and sec. 117 of the Code)	25
3. Repeal of exclusion of income from United States savings bonds used to pay higher education expenses (sec. 1203 of the discussion draft and sec. 135 of the Code).....	26
4. Repeal of deduction for interest on education loans (sec. 1204 of the discussion draft and sec. 221 of the Code)	27
5. Repeal of deduction for qualified tuition and related expenses (sec. 1205 of the discussion draft and sec. 222 of the Code)	28
6. No new contributions to Coverdell education savings accounts (sec. 1206 of the discussion draft and sec. 530 of the Code)	29
7. Repeal of exclusion for discharge of student loan indebtedness (sec. 1207 of the discussion draft and sec. 108(f) of the Code)	31
8. Repeal of exclusion for qualified tuition reductions (sec. 1208 of the discussion draft and sec. 117(d) of the Code)	32
9. Repeal of exclusion for education assistance programs (sec. 1209 of the discussion draft and sec. 127 of the Code)	32
10. Repeal of exception to 10-percent penalty for higher education (sec. 1210 of the discussion draft and sec. 72(t) of the Code)	33

D. Repeal of Certain Credits for Individuals	35
1. Repeal of dependent care credit (sec. 1301 of the discussion draft and sec. 21 of the Code).....	35
2. Repeal of credit for adoption expenses (sec. 1302 of the discussion draft and sec. 23 of the Code)	35
3. Nonbusiness energy property credit (sec.1303 of the discussion draft and sec. 25C of the Code).....	36
4. Credit for residential energy efficient property (sec. 1304 of the discussion draft and sec. 25D of the Code)	37
5. Repeal of credits for alternative fuel vehicles and alternative fuel refueling property (secs. 1305 through 1308 of the discussion draft and secs. 30, 30B, 30C, and 30D of the Code)	37
6. Repeal of credit for health insurance costs of eligible individuals (sec. 1309 of the discussion draft and sec. 35 of the Code)	38
7. Repeal of first time homebuyer credit (sec. 1310 of the discussion draft and sec. 36 of the Code)	40
E. Deductions, Exclusions, and Certain Other Provisions	41
1. Exclusion of gain from sale of a principal residence (sec. 1401 of the discussion draft and sec. 121 of the Code)	41
2. Mortgage interest (sec. 1402 of the discussion draft and sec. 163 of the Code)	42
3. Charitable contributions (sec. 1403 of the discussion draft and sec. 170 of the Code).....	44
4. Denial of deduction for expenses attributable to the trade or business of being an employee (sec. 1404 of the discussion draft and sec. 62(a)(2) and new sec. 262A of the Code).....	56
5. Repeal of deduction for taxes not paid or accrued in a trade or business (sec. 1405 of the discussion draft and sec. 164 of the Code).....	57
6. Repeal of deduction for personal casualty losses (sec. 1406 of the discussion draft and sec. 165 of the Code)	58
7. Limitation on wagering losses (sec. 1407 of the discussion draft and sec. 165(d) of the Code).....	59
8. Repeal of deduction for tax preparation expenses (sec. 1408 of the discussion draft and sec. 212 of the Code)	59
9. Repeal of deduction for medical expenses (sec. 1409 of the discussion draft and sec. 213 of the Code).....	60
10. Repeal of the disqualification of expenses for over-the-counter drugs under certain accounts and arrangements (sec. 1410 of the discussion draft and secs. 106 and 223 of the Code).....	60
11. Repeal of deduction for alimony payments and corresponding inclusion in gross income (sec. 1411 of the discussion draft and secs. 71 and 215 of the Code).....	63
12. Repeal of deduction for moving expenses (sec. 1412 of the discussion draft and sec. 217 of the Code).....	64
13. Termination of deduction and exclusions for contributions to medical savings accounts (sec. 1413 of the discussion draft and secs. 106(b) and 220 of the Code).....	64

14. Repeal of two-percent floor on miscellaneous itemized deductions (sec. 1414 of the discussion draft and sec. 67 of the Code).....	66
15. Repeal of overall limitation on itemized deductions (sec. 1415 of the discussion draft and sec. 68 of the Code)	68
16. Deduction for amortizable bond premium allowed in determining adjusted gross income (sec. 1416 of the discussion draft and sec. 62 of the Code).....	68
17. Repeal of exclusion, etc., for employee achievement awards (sec. 1417 of the discussion draft and secs. 74(c) and 274(j) of the Code).....	69
18. Clarification of special rule for certain governmental plans (sec. 1418 of the discussion draft and sec. 105(j) of the Code).....	69
19. Limitation on exclusion for employer-provided housing (sec. 1419 of the discussion draft and sec. 119 of the Code)	71
20. Fringe benefits (sec. 1420 of the discussion draft and sec. 132 of the Code).....	71
21. Repeal of exclusion of net unrealized appreciation in employer securities (sec. 1421 of the discussion draft and sec. 402(e)(4) of the Code).....	73
22. Consistent basis reporting between estate and person acquiring property from decedent (sec. 1422 of the discussion draft and secs. 6035 and 6724 of the Code).....	74
F. Employment Tax Modification.....	76
1. Modifications of deduction for Social Security taxes in computing net earnings from self-employment (sec. 1501 of the discussion draft and sec. 1402(a)(12) of the Code).....	76
2. Determination of net earnings from self-employment (sec. 1502 of the discussion draft and secs. 3101, 3102, 2111, 1401, and 1402 of the Code)	79
3. Repeal of exemption from FICA taxes for certain foreign workers (sec. 1503 of the discussion draft and secs. 3121(b)(1) and (b)(19) and section 3231(e)(1) of the Code).....	85
4. Repeal of exemption from FICA taxes for certain students (sec. 1504 of the discussion draft and sec. 3121(b)(2) and (b)(10) of the Code)	86
5. Override of Treasury guidance providing that certain employer-provided supplemental unemployment benefits are not subject to employment taxes (sec. 1505 of the discussion draft and sec. 3402(o)(1)(A) and (o)(2)(A) of the Code).....	89
6. Certified professional employer organizations (sec. 1506 of the discussion draft and new secs. 3511 and 7706 of the Code).....	91
G. Pensions and Retirement.....	100
1. Changes to rules for individual retirement arrangements (secs. 1601 through 1604 of the discussion draft and secs. 219, 408, and 408A of the Code).....	100
2. Repeal of exception to 10-percent penalty for first-time home purchases and elimination of first-time home purchase as a qualified distribution from a Roth IRA (sec. 1605 of the discussion draft and secs. 72(t) and 408A of the Code).....	104
3. Termination of new simplified employee pensions (sec. 1611 of the discussion draft and sec. 408(k) of the Code).....	105
4. Termination for new SIMPLE 401(k) plans (sec. 1612 of the discussion draft and sec. 401(k)(11) of the Code)	106

5. Rules related to designated Roth contributions (sec. 1613 of the discussion draft and secs. 401(a)(30), 402(g), 402A, and 408(p) of the Code)	107
6. Modification of required distribution rules for pension plans (sec. 1614 of the discussion draft and sec. 401(a)(9) of the Code)	111
7. Reduction in age for allowable in-service distributions (sec. 1615 of the discussion draft and secs. 401(a)(36) and sec. 457(d)(1) of the Code).....	119
8. Modification of rules governing hardship distributions (sec. 1616 of the discussion draft and sec. 401(k)(2) of the Code)	121
9. Extended rollover period for the rollover of plan loan offset amounts in certain cases (sec. 1617 of the discussion draft and sec. 402(c) of the Code).....	122
10. Coordination of contribution limitations for 403(b) plans and governmental 457(b) plans (sec. 1618 of the discussion draft and secs. 402(g), 403(b), 415 and 457(b) of the Code)	124
11. Application of 10 percent early distribution tax to governmental 457 plans (sec. 1619 of the discussion draft and sec. 72(t) of the Code).....	126
12. Inflation adjustments for employer-sponsored retirement plan dollar limitations on benefits and contributions (secs. 1620 to 1624 of the discussion draft and secs. 402(g), 415(d), and 408(p) of the Code)	128
H. Certain Provisions Related to Members of Indian Tribes.....	132
1. Indian general welfare benefits (secs. 1701-1703 of the discussion draft and new sec. 139E of the Code).....	132

INTRODUCTION

This document¹ provides a technical explanation of Title I of the Tax Reform Act of 2014, a discussion draft² prepared by the Chairman of the House Committee on Ways and Means that proposes to reform the Internal Revenue Code. Title I of the proposal addresses tax reform for individuals.

¹ This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways And Means to Reform the Internal Revenue Code: Title I— Tax Reform For Individuals*, (JCX-12-14), February 26, 2014. This document can also be found on our website at www.jct.gov.

² Statutory draft version Camp_041.XML.

TITLE I – TAX REFORM FOR INDIVIDUALS

A. Individual Income Tax Base Reform

1. Simplification of individual income tax rates (secs. 1001 and 1003 of the discussion draft and secs. 1 and 2 of the Code)

Present Law

In general

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her 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 increases.

Tax rate schedules

Separate rate schedules apply based on an individual's filing status. For 2014, the regular individual income tax rate schedules are as follows:

Table 1.–Federal Individual Income Tax Rates for 2014³

If taxable income is:	Then income tax equals:
Single Individuals	
Not over \$9,075	10% of the taxable income
Over \$9,075 but not over \$36,900	\$907.50 plus 15% of the excess over \$9,075
Over \$36,900 but not over \$89,350	\$5,081.25 plus 25% of the excess over \$36,900
Over \$89,350 but not over \$186,350	\$18,193.75 plus 28% of the excess over \$89,350
Over \$186,350 but not over \$405,100	\$45,353.75 plus 33% of the excess over \$186,350
Over \$405,100 but not over \$406,750	\$117,541.25 plus 35% of the excess over \$405,100
Over \$406,750	\$118,118.75 plus 39.6% of the excess over \$406,750

³ Sec. 3.01 of Rev. Proc. 2013-35, 2013-47 I.R.B. 537, 2013.

If taxable income is:	Then income tax equals:
Heads of Households	
Not over \$12,950	10% of the taxable income
Over \$12,950 but not over \$49,400	\$1,295 plus 15% of the excess over \$12,950
Over \$49,400 but not over \$127,550	\$6,762.50 plus 25% of the excess over \$49,400
Over \$127,550 but not over \$206,600	\$26,300 plus 28% of the excess over \$127,550
Over \$206,600 but not over \$405,100	\$48,434 plus 33% of the excess over \$206,600
Over \$405,100 but not over \$432,200	\$113,939 plus 35% of the excess over \$405,100
Over \$432,200	\$123,424 plus 39.6% of the excess over \$432,200
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over \$18,150	10% of the taxable income
Over \$18,150 but not over \$73,800	\$1,815 plus 15% of the excess over \$18,150
Over \$73,800 but not over \$148,850	\$10,162.50 plus 25% of the excess over \$73,800
Over \$148,850 but not over \$226,850	\$28,925 plus 28% of the excess over \$148,850
Over \$226,850 but not over \$405,100	\$50,765 plus 33% of the excess over \$226,850
Over \$405,100 but not over \$457,600	\$109,587.50 plus 35% of the excess over \$405,100
Over \$457,600	\$127,962.50 plus 39.6% of the excess over \$457,600
Married Individuals Filing Separate Returns	
Not over \$9,075	10% of the taxable income
Over \$9,075 but not over \$36,900	\$907.50 plus 15% of the excess over \$9,075
Over \$36,900 but not over \$74,425	\$5,081.25 plus 25% of the excess over \$36,900
Over \$74,425 but not over \$113,425	\$14,462.50 plus 28% of the excess over \$74,425
Over \$113,425 but not over \$202,550	\$25,382.50 plus 33% of the excess over \$113,425
Over \$202,550 but not over \$228,800	\$54,793.75 plus 35% of the excess over \$202,550

If taxable income is:	Then income tax equals:
Over \$228,800	\$63,981.25 plus 39.6% of the excess over \$228,800
Estates and Trusts	
Not over \$2,500	15% of the taxable income
Over \$2,500 but not over \$5,800	\$375 plus 25% of the excess over \$2,500
Over \$5,800 but not over \$8,900	\$1,200 plus 28% of the excess over \$5,800
Over \$8,900 but not over \$12,150	\$2,068 plus 33% of the excess over \$8,900
Over \$12,150	\$3,140.50 plus 39.6% of the excess over \$12,150

Unearned income of children

Special rules (generally referred to as the “kiddie tax”) apply to the net unearned income of certain children.⁴ Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child’s parents is alive at such time; (2) the child’s unearned income exceeds \$2,000 (for 2014); and (3) the child does not file a joint return.⁵ The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

Under these rules, the net unearned income of a child (for 2014, unearned income over \$2,000) is taxed at the parents’ tax rates if the parents’ tax rates are higher than the tax rates of the child.⁶ The remainder of a child’s taxable income (i.e., earned income, plus unearned income up to \$2,000 (for 2014), less the child’s standard deduction) is taxed at the child’s rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts.⁷ In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.⁸

⁴ Sec. 1(g). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

⁵ Sec. 1(g)(2).

⁶ Special rules apply for determining which parent’s rate applies where a joint return is not filed.

⁷ Sec. 1(g)(4) and sec. 911(d)(2).

⁸ Sec. 1(h).

The kiddie tax is calculated by computing the “allocable parental tax.” This involves adding the net unearned income of the child to the parent’s income and then applying the parent’s tax rate. A child’s “net unearned income” is the child’s unearned income less the sum of (1) the minimum standard deduction allowed to dependents (\$1,000 for 2014⁹), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.¹⁰

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child’s net unearned income to the parent’s taxable income.¹¹ If the child has net capital gains or qualified dividends, these items are allocated to the parent’s hypothetical taxable income according to the ratio of net unearned income to the child’s total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child’s net unearned income relative to the aggregate net unearned income of all of the parent’s children subject to the tax.

Generally, a child must file a separate return to report his or her income.¹² In such case, items on the parents’ return are not affected by the child’s income, and the total tax due from the child is the greater of:

1. The sum of (a) the tax payable by the child on the child’s earned income and unearned income up to \$2,000 (for 2014), plus (b) the allocable parental tax on the child’s unearned income, or
2. The tax on the child’s income without regard to the kiddie tax provisions.¹³

Under certain circumstances, a parent may elect to report a child’s unearned income on the parent’s return.¹⁴

Indexing tax provisions for inflation

Under present law, many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for all Urban Consumers (“CPI-U”).¹⁵ The CPI-U is an

⁹ Sec. 3.02 of Rev. Proc. 2013-35, *supra*.

¹⁰ Sec. 1(g)(4).

¹¹ Sec. 1(g)(3).

¹² Sec. 1(g)(6). See Form 8615, Tax for Certain Children Who Have Unearned Income.

¹³ Sec. 1(g)(1).

¹⁴ Sec. 1(g)(7).

¹⁵ Sec. 1(f)(5).

index that measures prices paid by typical urban consumers on a broad range of products, and is developed and published by the Department of Labor.

Among the inflation-indexed tax parameters are the following individual income tax amounts: (1) the regular income tax brackets; (2) the basic standard deduction; (3) the additional standard deduction for aged and blind; (4) the personal exemption amount; (5) the thresholds for the overall limitation on itemized deductions and the personal exemption phase-out; (6) the phase-in and phase-out thresholds of the earned income credit; (7) IRA contribution limits and deductible amounts; and (8) the saver's credit.

Description of Proposal

Modification of rates

In general

The proposal replaces the individual income tax rate structure with a new rate structure. The new rate structure generally has three rates, 10 percent, 25 percent and 35 percent, with the 35-percent rate composed of the 25-percent rate imposed on taxable income in excess of the 25-percent rate bracket threshold and an additional 10 percent tax on modified adjusted gross income (modified "AGI") in excess of \$450,000 for joint returns (\$400,000 for all other filers). The 25-percent rate bracket begins at taxable income of \$71,200 for joint returns and surviving spouses (\$35,600 for other individuals).¹⁶ Estates and trusts have only two rate brackets: a 25-percent bracket and 35-percent bracket, with the 35-percent rate composed of a 25 percent rate on taxable income and an additional 10 percent rate on modified AGI in excess of \$12,000. Modified AGI is described in more detail below.

The benefit of the 10-percent rate, as measured against the 25-percent rate on taxable income, is phased out if an individual's modified AGI exceeds a threshold of \$300,000 for joint filers and surviving spouses (\$250,000 for any other individual other than trusts and estates). For taxpayers whose modified AGI exceeds these thresholds, the benefit amounts to \$10,680 for joint filers and \$5,340 for all other filers. The benefit amount is phased out at a five-percent rate, and is thus fully phased out at modified AGI of \$513,600 (in the case of joint filers) or \$356,800 (in the case of other individual taxpayers) above the threshold amount.

The bracket thresholds, and the threshold at which the benefit of the 10-percent rate begins to be phased out, are all adjusted for inflation using a base year of 2013, and then rounded to the next lowest multiple of \$100 in future years. Unlike present law (which uses a measure of the consumer price index for all-urban consumers), the new inflation adjustment uses the chained consumer price index for all-urban consumers.

For purposes of the 35-percent bracket and the phaseout of the benefit of the 10-percent bracket, modified AGI is defined as AGI increased by:

¹⁶ The proposal repeals head of household filing status.

(i) any amount excluded from income under sections 911 (related to exclusions from income for citizens or residents of the United States living abroad), 931, and 933;

(ii) any amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax (less any amounts disallowed as a deduction for investment interest with respect to tax-exempt interest,¹⁷ and amortizable bond premiums on tax-exempt bonds¹⁸);

(iii) any amount excluded by the taxpayer as a cost of employer-sponsored health coverage;

(iv) amounts paid by a self-employed individual for health insurance deducted under section 162(l);

(v) pre-tax contributions to tax-favored defined contribution retirement plans;

(vi) deductible health savings account (“HSA”) contributions; and

(vii) excluded Social Security and tier I railroad retirement benefits; and

reduced by

(i) charitable contributions to the extent eligible for a deduction under section 170, but only if the taxpayer itemizes his or her deductions; and

(ii) qualified domestic manufacturing income.

Qualified domestic manufacturing income

For these purposes, qualified domestic manufacturing income is equal to domestic manufacturing gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic manufacturing gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any lease, rental, license, sale, exchange, or other disposition of tangible personal property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;¹⁹ or (2) in the case of a taxpayer engaged in the

¹⁷ See the description of section 3124 of the discussion draft, “Prevention of arbitrage of deductible interest expense and tax-exempt interest income.”

¹⁸ Sec. 171(a)(2).

¹⁹ When used in the Code in a geographical sense, the term “United States” generally includes only the States and the District of Columbia. However, in determining domestic manufacturing gross receipts, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term “United States” includes the Commonwealth of Puerto Rico, but only if all of the taxpayer’s Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations.

active conduct of a construction trade or business, construction of real property performed in the United States by a taxpayer in the ordinary course of such trade or business if such real property is placed in service after December 31, 2014.

Under the proposal, tangible personal property does not include computer software²⁰ or any motion picture films, video tapes, or sound recordings.²¹

However, domestic manufacturing gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person. Further, domestic manufacturing gross receipts do not include any gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment; that are derived from the transmission or distribution of electricity, natural gas, or potable water; and that are derived from the lease, rental, license, sale, exchange, or other disposition of land. Domestic manufacturing gross receipts also do not include any gross receipts which are properly allocable to the taxpayer's net earnings from self employment,²² or any amount attributable to a qualified change in method of accounting²³ and/or any other change in method of accounting required by the discussion draft.²⁴

A special rule for government contracts provides that property that is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government is considered to be domestic manufacturing gross receipts even if title or risk of loss is transferred to the Federal Government before the manufacture or production of such property is complete to the extent required by the Federal Acquisition Regulation.

With respect to the domestic manufacturing income of a partnership or S corporation, each partner or shareholder generally will take into account such person's allocable share of the components of the calculation (including domestic manufacturing gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions properly allocable to such receipts) from the partnership or S corporation. For a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary under regulations prescribed by the Secretary. However, in the case of a publicly

²⁰ It is intended that any lease, rental, license, sale, exchange, or other disposition of computer software, regardless of the method (*e.g.*, provided via a tangible medium, downloaded from the internet, accessed on the cloud, or any similar transaction) is excluded from the definition of "domestic manufacturing gross receipts."

²¹ "Sound recordings" are any works resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material (*e.g.*, discs, tapes, or other phonorecordings) in which such sounds are embodied. Sec. 168(f)(4).

²² For a discussion of net earnings from self-employment, see the description of section 3621 of the discussion draft, "Ordinary income treatment in the case of partnership interests held in connection with performance of services."

²³ For a discussion of a qualified change in method of accounting, see the description of section 3301 of the discussion draft, "Limitation on use of cash method of accounting."

²⁴ See, *e.g.*, section 3310 of the discussion draft, "Repeal of last-in, first-out method of inventory."

traded partnership described in section 7704(c), each partner shall not take into account any allocable share of the aforementioned components of the calculation.

A phase-in is provided for taxable years beginning before January 1, 2017: for any taxable year beginning in 2015, only 33 percent of a taxpayer's qualified domestic manufacturing income reduces AGI; and for any taxable year beginning in 2016, only 67 percent of a taxpayer's qualified domestic manufacturing income reduces AGI.

Simplification of tax on unearned income of children

The proposal simplifies the “kiddie tax” by effectively applying the rates applicable to trusts to the net unearned income of a child to whom the proposal applies. Specifically, the amount of taxable income taxed at a 10-percent rate may not exceed the amount of taxable income in excess of the net unearned income of the child. The amount of taxable income taxed at rates below 35 percent may not exceed sum of (1) the taxable income in excess of the net unearned income of the child plus (2) the amount of taxable income not in excess of the 35-percent bracket threshold in the case of a trust.

The following examples illustrate the application of the proposal:

Example 1.—Assume a child to whom the “kiddie tax” applies has \$60,000 taxable income (and modified AGI) of which \$50,000 is net unearned income. Assume the 25-percent bracket threshold amount for the taxable year is \$35,600 for an unmarried taxpayer (other than a child subject to the “kiddie tax”), and the 35-percent bracket threshold for a trust is \$12,000.

The child's 25-percent bracket threshold is \$10,000 (\$60,000 less \$50,000) and 35-percent bracket threshold is \$22,000 (\$10,000 plus \$12,000). Thus, \$10,000 is taxed at a 10-percent rate, \$12,000 is taxed at a 25-percent rate, and \$38,000 is taxed at a 35-percent rate.

Example 2.—Assume the same facts as in Example 1 except that the amount of the child's net unearned income is \$20,000 (rather than \$50,000).

The child's 25-percent bracket threshold is \$35,600 and 35-percent bracket threshold is \$52,000 (\$40,000 (\$60,000 less \$20,000) plus \$12,000). Thus, \$35,600 is taxed at a 10-percent rate, \$16,400 is taxed at a 25-percent rate, and \$8,000 is taxed at a 35-percent rate.

Replacing CPI-U with chained CPI-U

The proposal requires the use of the chained CPI-U (“C-CPI-U”) to index tax parameters currently indexed by the CPI-U. The C-CPI-U is developed and published by the Department of Labor, and differs from the CPI-U in that it accounts for the ability of individuals to alter their consumption patterns in response to relative price changes.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Deduction for capital gains and dividends of individuals (sec. 1002 of the discussion draft and sec. 169 of the Code)

Present Law

In general

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15-percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

In addition, a 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, which includes gains and dividends, or the excess of modified adjusted gross income over the threshold amount. 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 the case of any other individual.

Definitions

Net capital gain

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. 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. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Adjusted net capital gain

The “adjusted net capital gain” of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

Qualified dividend income

Adjusted net capital gain is increased by the amount of qualified dividend income.

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits. Qualified dividends generally includes dividends received from domestic corporations and qualified foreign corporations. The term “qualified foreign corporation” includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company (“RIC”) for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (1) the qualified dividend income of the RIC for the taxable year and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of qualified dividend income that may be paid by a real estate investment trust (“REIT”) for any taxable year may not exceed the sum of (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the

amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

Dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities are not qualified dividend income.

28-percent rate gain

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

Unrecaptured section 1250 gain

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

Description of Proposal

The proposal repeals the present-law maximum tax rates for capital gain and dividends. The proposal provides a deduction in computing adjusted gross income equal to 40 percent of the adjusted net capital gain of an individual.

Adjusted net capital gain means net capital gain reduced (but not below zero) by the net collectibles gain and increased by the qualified dividend income.

The 3.8 percent tax on net investment income is not affected by the proposal.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

B. Simplification of Tax Benefits for Families

1. Standard deduction (sec. 1101 of the discussion draft and sec. 63 of the Code)

Present Law

Under present law, a taxpayer may reduce his adjusted gross income ("AGI") by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2014, the amount of the standard deduction is \$6,200 for single individuals and married individuals filing separate returns, \$9,100 for heads of households, and \$12,400 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.²⁵ The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deduction, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI (7.5 percent for certain taxpayers over age 65)), casualty and theft losses (in excess of \$100 per loss and in excess of 10 percent of AGI), and certain miscellaneous expenses (in excess of two percent of AGI).

Description of Proposal

The proposal increases the standard deduction for taxpayers across all filing statuses. Under the proposal, the amount of the standard deduction is \$22,000 for married individuals filing a joint return and \$11,000 for all other taxpayers (the proposal eliminates head of household filing status). The amount of the standard deduction is indexed for inflation using the chained consumer price index for all-urban consumers.²⁶

The proposal also provides that the amount of the standard deduction is phased out by 20 percent of every dollar that a taxpayer's modified AGI exceeds \$513,600²⁷ for joint filers (\$356,800 for all other filers).²⁸ Thus, using the nominal values, the standard deduction will be completely phased out when a taxpayer's modified AGI reaches \$623,600 in the case of a joint

²⁵ For 2014, the additional amount is \$1,200 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,650. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2014) of \$2,400 or \$3,300, as applicable.

²⁶ The standard deduction amounts are set at 2013 levels. Thus, in 2015 the amounts of the standard deduction will be \$11,000 and \$22,000, plus an adjustment for two years of inflation.

²⁷ The phaseout threshold amounts are set at 2013 levels. Thus, in 2015 the threshold amounts will be \$513,600 for joint filers (\$356,800 for all other filers), plus an adjustment for two years of inflation.

²⁸ For a description of modified AGI, see the description of section 1001 of the proposal.

return (and \$411,800 in any other case). The threshold amount at which the phaseout begins is indexed for inflation.²⁹

To provide parity with those who itemize their deductions, the proposal also provides for a phaseout of \$22,000 of itemized deductions, in the case of joint filers (\$11,000 for all other filers) over the same modified AGI range. Thus, if a joint filer had \$40,000 in itemized deductions, this amount would be reduced to \$18,000 (*i.e.*, the \$22,000 value of the standard deduction would be phased out) as the taxpayer's modified AGI went from \$513,600 to \$623,600.

The proposal eliminates the additional standard deduction for the aged and the blind.

The proposal provides for an additional above-the-line deduction for unmarried individuals with at least one qualifying child. These individuals are entitled to an additional deduction of \$5,500 (indexed for inflation).³⁰ This additional deduction is phased out for every dollar by which a taxpayer's AGI exceeds \$30,000 (this threshold is adjusted for inflation).

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Increase and expansion of child tax credit (sec. 1102 of the discussion draft and sec. 24 of the Code)

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is \$1,000. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income ("AGI") over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against both the regular tax and the alternative minimum tax ("AMT"). To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is

²⁹ The phaseout thresholds are set at 2013 levels. Thus, in 2015 the phaseout thresholds will be the nominal amounts above, plus an adjustment for two years of inflation.

³⁰ The additional standard deduction amount is set at 2013 levels. Thus, in 2015 the \$5,500 amount will be adjusted based on two years of inflation.

eligible for a refundable credit³¹ (the “additional child tax credit”) equal to 15 percent of earned income in excess of a threshold dollar amount (the “earned income” formula). Prior to the enactment of the American Recovery and Reinvestment Act of 2009 (“ARRA”), the threshold dollar amount was \$10,000 and was indexed for inflation. Under the ARRA, the threshold amount was lowered to \$3,000 (the \$3,000 amount is not indexed). The \$3,000 threshold is currently scheduled to expire for taxable years beginning after December 31, 2017, after which the threshold reverts to the indexed \$10,000 amount (\$13,600 for 2014).

Families with three or more children may determine the additional child tax credit using the “alternative formula,” if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer’s Social Security taxes exceed the taxpayer’s earned income credit (“EIC”).

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer’s election, combat pay may be treated as earned income for these purposes. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers’ parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and is not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Description of Proposal

The proposal increases the child tax credit to \$1,500 per qualifying child and raises the age limit by one year to include qualifying children under age 18 (\$500 for other qualifying dependents).³² The proposal generally retains the present-law definition of dependent. However, the definition of a qualifying child is limited to individuals who are citizens or nationals of the United States. The credit amounts are indexed for inflation.³³

³¹ The refundable credit may not exceed the maximum credit per child of \$1,000.

³² For a description of the modifications to the definition of a qualifying child, see the description of section 1104 of the discussion draft.

³³ The credit amounts are set at 2013 levels. Thus, in 2015 the credit amounts will be \$500 and \$1,500, plus an adjustment for two years of inflation.

The credit is phased out for higher-income individuals. Specifically, a taxpayer's child tax credit is reduced at a rate of five percent of the taxpayer's modified AGI as exceeds \$623,600³⁴ for joint filers (\$411,800 for other filers).³⁵ These thresholds are indexed for inflation.³⁶

The child tax credit is partially refundable against the individual's income tax liability. The refundable portion is limited to the lesser of: (1) the child tax credit otherwise allowed, or (2) 25 percent of the taxpayer's earned income. Earned income is defined as a taxpayer's wages, salaries, tips and other employee compensation includible in gross income for the taxable year, plus the taxpayer's net earnings from self-employment income for the taxable year (determined with regard to the deduction allowed to the taxpayer by section 164(f)). For purposes of calculating a taxpayer's refundable child credit, for taxable years beginning prior to 2018, a taxpayer must reduce earned income by \$3,000 (but not below zero). Additionally, the proposal provides that a taxpayer is not allowed the refundable child tax credit for a taxable year in which the taxpayer excludes any amount from gross income under section 911 (relating to the exclusion of foreign earned income).

The proposal requires that the taxpayer include the name and taxpayer identification number of each qualifying child and dependent on the tax return for each taxable year. In the case of a refundable child tax credit the taxpayer must include the taxpayer's Social Security number on the tax return for the taxable year (in the case of a joint return either spouse's Social Security number will suffice). The Internal Revenue Service may assess a deficiency in tax arising from the failure to include the Social Security number on the tax return as a mathematical or clerical error.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

3. Modification of earned income tax credit (sec. 1103 of the discussion draft and sec. 32 of the Code)

Present Law

In general

Low- and moderate-income workers may be eligible for the refundable earned income credit ("EIC"). Eligibility for the EIC is based on earned income, adjusted gross income

³⁴ The phaseout threshold amounts are set at 2013 levels. Thus, in 2015 the threshold amounts will be \$623,600 for joint filers (\$411,800 for all other filers), plus an adjustment for two years of inflation.

³⁵ See the description of section 1001 of the discussion draft for a description of modified AGI.

³⁶ The phaseout thresholds are indexed using 2013 as the base year. Thus, in 2015 the phaseout thresholds will be \$627,500, plus an adjustment for the change in the average chained consumer price index between August 31, 2013 and August 31, 2014.

(“AGI”), investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker’s family, as well as on adjusted gross income and earned income.

The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,350 (for 2014). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer’s Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children. The values below are for 2014.³⁷

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$6,480, resulting in a maximum credit of \$496. The maximum is available for those with incomes between \$6,480 and \$8,110 (\$13,540

³⁷ All income thresholds are indexed for inflation annually.

if married filing jointly). At that point, the credit begins to phase out at a rate of 7.65 percent of earnings above that threshold, resulting in a \$0 credit at \$14,590 of earnings (\$20,020 if married filing jointly).

Taxpayers with one qualifying child may claim a credit of 34 percent of their earnings up to \$9,720, resulting in a maximum credit of \$3,305. The maximum credit is available for those with earnings between \$9,720 and \$17,830 (\$23,260 if married filing jointly). At that point, the credit begins to phase out at a rate of 15.98 percent of earnings above this threshold, phasing out completely at \$38,511 of earnings (\$43,941 if married filing jointly).

Taxpayers with two qualifying children may claim a credit of 40 percent of earnings up to \$13,650, resulting in a maximum credit of \$5,460. The maximum credit is available for those with earnings between \$13,650 and \$17,830 (\$23,260 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at \$43,756 of earnings (\$49,186 if married filing jointly).

A temporary provision recently extended by the American Taxpayer Relief Act of 2012 (“ATRA”)³⁸ allows taxpayers with three or more qualifying children to claim the EIC at an increased rate of 45 percent for taxable years before 2018. Thus, in 2014 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to \$13,650, resulting in a maximum credit of \$6,143. The maximum credit is available for those with earnings between \$13,650 and \$17,830 (\$23,260 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at \$46,997 of earnings (\$52,427 if married filing jointly).

A temporary provision recently extended by the ATRA increases the phase-out thresholds for married couples to an amount \$5,000 (indexed for inflation from 2009)³⁹ above that for other filers. The increase is \$5,430 for 2014. This increase expires for taxable years beginning after December 31, 2017.

Description of Proposal

The proposal modifies the EIC. Under the proposal, certain low-income taxpayers are entitled to a credit equal to the amount of the individual's employment-related taxes for the taxable year. The maximum credit for a taxpayer with two or more qualifying children is \$3,000 (\$4,000 for those who file joint returns). For taxpayers with one qualifying child,⁴⁰ the maximum credit is \$2,400 (regardless of filing status). For taxpayers with no qualifying children, the maximum credit is \$100 (\$200 for those who file joint returns). For individuals who pay Federal Insurance Contributions Act (“FICA”) or Railroad Retirement Tax Act

³⁸ Pub. L. No. 112-240.

³⁹ A technical correction may be necessary to reflect that the \$5,000 amount is indexed.

⁴⁰ For a description of changes to the definition of a qualifying child, see the description of section 1104 of the discussion draft.

(“RRTA”) taxes under section 3101 or 3201, respectively, the credit is first credited against the employee share of such taxes, but may not reduce the employee share of such taxes below zero.⁴¹ Any section 32 credit available to be applied against income tax is reduced by the amount of any credit applied against the taxes imposed by section 3101 or 3201.

For these purposes, employment-related taxes with respect to any taxpayer for any taxable year is the sum of: (1) the employee share and the employer share of FICA tax on the taxpayer's wages received during the calendar year in which the taxable year begins; (2) any RRTA tax imposed (*i.e.*, on employees, employers, and employee representatives) on compensation received by the taxpayer during the calendar year in which the taxable year begins; and (3) any Self-Employment Contributions Act (“SECA”) tax imposed on the self-employment income of the taxpayer for the taxable year. For these purposes, the definition of wages is the same as used for FICA tax purposes in section 3121(a) and the definition of compensation is the same as used for Railroad Retirement Tax purposes in section 3231(e). In the case of taxpayers with no qualifying children, for purposes of the credit, employment-related taxes are defined as the employee share of FICA or RRTA taxes, or, in the case of any SECA tax imposed on the taxpayer, one-half of such amount.

In the case of taxpayers with qualifying children, the credit is phased-down by the sum of: (1) 19 percent of the taxpayer's AGI over \$27,000 in the case of taxpayers filing a joint return (\$20,000 for all other filers); and (2) 100 percent of the taxpayer's investment income as exceeds \$3,300. The definition of investment income for these purposes is unchanged from present law.⁴² For taxpayers with no qualifying children, the credit is phased down by the sum of (1) 19 percent of the taxpayer's AGI over \$13,000 in the case of taxpayers filing a joint return (\$8,000 for all other filers), and (2) 100 percent of the taxpayer's investment income as exceeds \$3,300.

For tax years beginning prior to 2018, taxpayers with qualifying children are allowed an EIC for up to 200 percent of employment-related taxes, subject to the applicable maximum credit. For tax years beginning prior to 2018, the applicable maximum credit for taxpayers with two or more children is \$4,000, regardless of filing status (that is, the maximum credit is increased by \$1,000 for taxpayers with two or more children who do not file a joint return), and the maximum applicable credit for taxpayers with one child is increased by \$600, to \$3,000.

⁴¹ The credit is not taken into account in determining the amount of FICA or RRTA tax required to be withheld from an employee's wages or compensation, rather, it is generally taken as a credit on an individual's income tax return.

⁴² For these purposes, investment income means the sum of (1) interest or dividends received in the taxable year; (2) tax-exempt interest received or accrued during the taxable year; (3) net income derived from rents or royalties during the taxable year, not received in the ordinary course of a trade or business; (4) net capital gain income for the taxable year; and (5) net income derived from passive activities during the taxable year.

Both the maximum amount of the credit and income thresholds for the phaseout of the credit are indexed for inflation.⁴³

No credit is allowed unless the taxpayer includes on the tax return for the taxable year the taxpayer's Social Security number. In the case of taxpayers filing a joint return, this identification requirement will be satisfied if the Social Security number of either spouse is included on the tax return. Additionally, a child shall not be considered a qualifying child for purposes of the credit unless the return includes the name, age and Social Security number of that child. The Secretary of the Treasury or his designee may prescribe other methods for satisfying the second identification requirement.

The proposal also requires the Secretary of the Treasury (or the Secretary's designee) to submit a report to Congress within 180 days of the date of enactment, making recommendations regarding the best method for providing for advance payment of the EIC. The recommendations in the report shall seek to 1) provide for the payment of the EIC as promptly as is feasible, and 2) minimize any administrative burdens on employers and the IRS.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

4. Repeal of deduction for personal exemptions (sec. 1104 of the discussion draft and sec. 151 of the Code)

Present Law

Under present law, in determining taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2014, the amount deductible for each personal exemption is \$3,950. This amount is indexed annually for inflation.

Withholding rules

Under present law, the amount of tax required to be withheld by employers from a taxpayer's wages is based in part on the number of withholding exemptions a taxpayer claims on his Form W-4. An employee is entitled to the following exemptions: (1) an exemption for himself, unless he allowed to be claimed as a dependent of another person; (2) an exemption to which the employee's spouse would be entitled, if that spouse does not file a Form W-4 for that taxable year claiming an exemption described in (1); (3) an exemption for each individual who is a dependent (but only if the employee's spouse has not also claimed such a withholding exemption on a Form W-4); (4) additional withholding allowances (taking into account estimated

⁴³ Both the maximum credit value and the phaseout thresholds are set at 2013 levels. Thus, in 2015 the maximum credit values and phaseout thresholds will be the nominal amounts described above, plus an adjustment for two years of inflation.

itemized deductions, estimated tax credits, and additional deductions as provided by the Secretary of the Treasury); and (5) a standard deduction allowance.

Filing requirements

Under present law, an unmarried individual is required to file a tax return for the taxable year if in that year the individual had income which equals or exceeds the exemption amount plus the standard deduction applicable to such individual (*i.e.*, single, head of household, or surviving spouse). An individual entitled to file a joint return is required to do so unless that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, provided that such individual and his spouse, at the close of the taxable year, had the same household as their home.

Qualifying Children

Present law contains numerous provisions, including the dependency exemption, that provide benefits for taxpayers with children. In general, a child is a qualifying child of a taxpayer (and thus eligible for these benefits) if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the *residency test*, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Special rules apply in the case of divorced or separated parents. The *relationship test* requires that the individual is the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (for example, the taxpayer's grandchild). Additionally, the child can be the taxpayer's brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them (for example, the taxpayer's niece or nephew).⁴⁴

The *age test* varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child. In general, no age limit applies with respect to individuals who are totally and permanently disabled at any time during the calendar year. There are exceptions to these general rules. Two notable exceptions are: (1) a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit and (2) a child must be under age 17 (whether or not disabled) for purposes of the child credit.

⁴⁴ For purposes of determining whether an adopted child is treated as a child by blood, an adopted child qualifies if he or she is an individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.

Description of Proposal

The proposal repeals the deduction for personal exemptions.

The proposal modifies the requirements for those who are required to file a tax return. In the case of an individual who is not married, such individual is required to file a tax return if the taxpayer's gross income for the taxable year exceeds the applicable standard deduction. Married individuals are required to file a return if that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is more than the standard deduction applicable to a joint return, provided that: (i) such individual and his spouse, at the close of the taxable year, had the same household as their home; (ii) the individual's spouse does not make a separate return; and (iii) neither the individual nor his spouse is a dependent of another taxpayer and has income (other than earned income) in excess of \$500.

The proposal modifies the age test for a qualifying child. Under the proposal, a child may only be a qualifying child if that child has not attained the age of 18 as of the close of the calendar year in which the taxable year of the taxpayer begins. Under the proposal, as under present law, there is no age test for an individual who is permanently and totally disabled.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

C. Simplification of Education Benefits

1. American opportunity Tax credit (sec. 1201 of the discussion draft and sec. 25A of the Code)

Present Law

Hope credit and American Opportunity credit

For taxable years beginning before 2009 and after 2017, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,950 (estimated 2014 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.⁴⁵ The Hope credit rate is 100 percent on the first \$1,300 of qualified tuition and related expenses, and 50 percent on the next \$1,300 of qualified tuition and related expenses. These dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,300 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income ("AGI") phaseout described below) for a \$1,300 Hope credit. If a taxpayer incurs \$2,600 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,950 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$55,000 and \$65,000 (\$110,000 and \$130,000 for married taxpayers filing a joint return) for 2014, based on inflation adjustments determined by the staff of the Joint Committee on Taxation. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of \$1,000. The size of the phaseout ranges for single and married taxpayers are always \$10,000 and \$20,000 respectively.

A taxpayer may not claim the Hope credit if the qualified tuition and related expenses for the enrollment or attendance of a student, if such student has been convicted of a Federal or State felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year.⁴⁶

For taxable years beginning after December 31, 2008, individual taxpayers are eligible to claim the American Opportunity credit, which refers to modifications to the Hope credit that apply for taxable years 2009 through 2017.⁴⁷ The maximum allowable modified credit is \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses,

⁴⁵ Sec. 25A(a)(1).

⁴⁶ Sec. 25A(b)(2)(D).

⁴⁷ Sec. 25A(i).

and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials. Forty percent of a taxpayer's otherwise allowable modified credit is refundable. The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Lifetime learning credit

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. Up to \$10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is \$2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

In contrast to the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years.⁴⁸ Also in contrast to the Hope and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the Hope credit is computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$55,000 and \$65,000 (\$110,000 and \$130,000 for married taxpayers filing a joint return) in 2014, based on inflation adjustments determined by the staff of the Joint Committee on Taxation. These phaseout ranges are the same as those for the Hope credit as it applies for tax years beginning before 2009, and are similarly indexed for inflation.

Reporting requirements

Section 6050S imposes reporting requirements, related to higher education tax benefits, on eligible educational institutions if the institution receives payments for qualified tuition and related expenses with respect to any individual for any calendar year. The information an institution subject to the reporting requirements is required to provide includes providing either the aggregate amount of payments received or the aggregate amount billed for qualified tuition and related expenses during the calendar year period.⁴⁹

Description of Proposal

The proposal permanently replaces the Hope credit with the American Opportunity credit and also modifies the American Opportunity credit. As under present law, the credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next

⁴⁸ Sec. 25A(a)(2).

⁴⁹ Sec. 6050S(b)(2)(B)(i).

\$2,000 of qualified tuition and related expenses, for a maximum credit of \$2,500. Under the proposal, the taxpayer's credit for the first \$1,500 of qualified tuition and related expenses is refundable.

The proposal lowers the phaseout range of the credit. The credit phases out for joint filers with modified AGI between \$86,000 and \$126,000, and for all other filers with modified AGI between \$43,000 and \$63,000. Both the credit amounts and the phaseout ranges are indexed for inflation beginning in 2018.

The proposal repeals the provision that denies the credit with respect to qualified tuition and related expenses for the enrollment or attendance of any student who has been convicted of a felony offense consisting of the possession or distribution of a controlled substance.

The proposal contains a provision that coordinates the credit with Pell Grants, such that Pell Grant amounts are deemed to first apply to expenses other than the qualified tuition and related expenses that are eligible for the credit. Thus, for purposes of calculating the credit, qualified tuition and related expenses are reduced by Pell Grant amounts only to the extent the Pell Grant exceeds the cost of college attendance (other than qualified tuition and related expenses).

The proposal modifies present-law reporting requirements, such that an eligible institution may only report the aggregate amount of tuition received with respect to any individual during the calendar year period. Additionally, the proposal adds a requirement that any taxpayer claiming the credit must include on the tax return the Employer Identification Number of any institution to whom qualified tuition was paid.

The proposal repeals the Lifetime Learning credit.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Expansion of Pell grant exclusion from gross income (sec. 1202 of the discussion draft and sec. 117 of the Code)

Present Law

Present law provides an exclusion from gross income and wages for amounts received as a qualified scholarship by an individual who is a candidate for a degree at a qualifying educational organization.⁵⁰ Generally, the exclusion does not apply to amounts received by a student that represent payment for teaching, research, or other services by the student as a condition for receiving the scholarship.

⁵⁰ Secs. 117(a), 3121(a)(20).

In general, a qualified scholarship is any amount received by such an individual as a scholarship or fellowship grant if the amount is used for qualified tuition and related expenses. Qualified tuition and related expenses include tuition and fees required for enrollment or attendance, or for fees, books, supplies, and equipment required for courses of instruction, at the qualifying educational organization. This definition does not include regular living expenses, such as room and board. A qualifying educational organization is an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

Description of Proposal

The proposal modifies the exclusion for qualified scholarships by providing that Federal Pell Grants under section 401 of the Higher Education Act of 1965⁵¹ are excluded from gross income, without regard to whether the grant is used for qualified tuition and related expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Repeal of exclusion of income from United States savings bonds used to pay higher education expenses (sec. 1203 of the discussion draft and sec. 135 of the Code)

Present Law

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.⁵² Qualified higher education expenses include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain eligible higher educational institutions. The amount of qualified higher education expenses taken into account for purposes of the exclusion is reduced by the amount of such expenses taken into account in determining the Hope, American Opportunity, or Lifetime Learning credits claimed by any taxpayer, or taken into account in determining an exclusion from gross income for a distribution from a qualified tuition program or a Coverdell education savings account, with respect to a particular student for the taxable year.

The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 2014, the exclusion is phased out for taxpayers with modified AGI between \$76,000 and \$91,000 (\$113,950 and \$143,950 for married taxpayers filing a joint return). To prevent taxpayers from effectively avoiding the income phaseout limitation through the purchase of bonds directly in the child's

⁵¹ 20 U.S.C. sec. 1070(a).

⁵² Sec. 135.

name, the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Description of Proposal

The proposal repeals the exclusion of interest earned on U.S. Series EE savings bonds described above.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

4. Repeal of deduction for interest on education loans (sec. 1204 of the discussion draft and sec. 221 of the Code)

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.⁵³ Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.⁵⁴

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is \$2,500.⁵⁵ For 2014, the deduction is phased out ratably for taxpayers with AGI between \$65,000 and \$80,000 (\$130,000 and \$160,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

⁵³ Sec. 221.

⁵⁴ Sec. 221(c).

⁵⁵ Sec. 221(b)(1).

Description of Proposal

The proposal repeals the deduction for interest on education loans.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

5. Repeal of deduction for qualified tuition and related expenses (sec. 1205 of the discussion draft and sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.⁵⁶ Qualified tuition includes tuition and fees required for the enrollment or attendance by the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution. The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose AGI for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose AGI does not exceed \$80,000 (\$160,000 in the case of a joint return).⁵⁷ No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2013.

Description of Proposal

The proposal repeals the deduction for qualified tuition and related expenses.

Effective Date

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

⁵⁶ Sec. 222(a).

⁵⁷ Sec. 222(b)(2)(B).

6. No new contributions to Coverdell education savings accounts (sec. 1206 of the discussion draft and sec. 530 of the Code)

Present Law

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.⁵⁸ Annual contributions to Coverdell education savings accounts may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.⁵⁹ However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (*i.e.*, the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.⁶⁰

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include qualified elementary and secondary expenses and qualified higher education expenses. Such qualified education expenses generally include only out-of-pocket expenses. They do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income.

⁵⁸ Sec. 530.

⁵⁹ In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

⁶⁰ This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

The term qualified elementary and secondary school expenses, means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

The term qualified higher education expenses includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.⁶¹ Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.⁶²

Description of Proposal

The proposal provides that, except in the case of rollover contributions from another Coverdell account, no contributions to Coverdell education savings accounts shall be accepted by such an account after December 31, 2014. Additionally, the proposal provides that qualified tuition programs⁶³ may accept rollover distributions from a Coverdell education savings account on a tax-free basis after December 31, 2014.

Effective Date

The proposal is effective for contributions and distributions made after December 31, 2014.

⁶¹ Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

⁶² Sec. 530(b)(2)(B).

⁶³ Sec. 529.

7. Repeal of exclusion for discharge of student loan indebtedness (sec. 1207 of the discussion draft and sec. 108(f) of the Code)

Present Law

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.⁶⁴

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain State loan repayment programs.

Description of Proposal

The proposal repeals the above-described exclusion from income for student loan forgiveness.

⁶⁴ Sec. 108(f).

Effective Date

The proposal applies to amounts discharged after December 31, 2014.

8. Repeal of exclusion for qualified tuition reductions (sec. 1208 of the discussion draft and sec. 117(d) of the Code)

Present Law

Present law provides an exclusion from gross income and wages for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.⁶⁵ The exclusion does not apply to any amount received by a student that represents payment for teaching, research or other services by the student required as a condition for receiving the tuition reduction.⁶⁶

Description of Proposal

The proposal repeals the exclusion for qualified tuition reductions.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

9. Repeal of exclusion for education assistance programs (sec. 1209 of the discussion draft and sec. 127 of the Code)

Present Law

If certain requirements are satisfied, up to \$5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes.⁶⁷ This exclusion applies to both graduate and undergraduate courses. For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer.⁶⁸

⁶⁵ Sec. 117(d).

⁶⁶ The exclusion applies with respect to highly compensated employees only if such tuition reductions are available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification established by the employer, such that the benefit does not discriminate in favor of highly compensated employees.

⁶⁷ Secs. 127, 3121(a)(18).

⁶⁸ The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, and (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (*i.e.*, it does not apply to education provided to the spouse or a child of the employee).

Description of Proposal

The proposal repeals the exclusion for income attributable to an education assistance program.

Effective Date

The proposal is effective for amounts paid or incurred in taxable years beginning after December 31, 2014.

10. Repeal of exception to 10-percent penalty for higher education (sec. 1210 of the discussion draft and sec. 72(t) of the Code)

Present Law

The Code imposes an early distribution tax on distributions made from qualified retirement plans, section 403(b) plans and individual retirement accounts (“IRAs”) before an employee (or an IRA owner) attains age 59½ unless an exception applies.⁶⁹ The tax is equal to 10 percent of the amount of the distribution that is includible in gross income.⁷⁰ One of the exceptions to the early distribution tax is for distributions from IRAs used for qualified higher education expenses.⁷¹

Description of Proposal

The proposal repeals the exception from the 10-percent early distribution tax that applies to distributions from IRAs that are made before age 59½ and used for qualified higher education expenses.

individuals consisting of more-than-five-percent owners of the employer and the spouses or dependents of such more-than-five-percent owners.

⁶⁹ Sec. 72(t).

⁷⁰ The 10-percent tax is in addition to the taxes that would otherwise be due on distribution.

⁷¹ Sec. 72(t)(2)(E) and (7).

Effective Date

The proposal applies to distributions after December 31, 2014.

D. Repeal of Certain Credits for Individuals

1. Repeal of dependent care credit (sec. 1301 of the discussion draft and sec. 21 of the Code)

Present Law

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 35 percent of a limited amount of employment-related dependent care expenses. Eligible child and dependent care expenses related to employment are limited to \$3,000 if there is one qualifying individual or \$6,000 if there are two or more qualifying individuals. Thus, the maximum credit is \$1,050 if there is one qualifying individual and \$2,100 if there are two or more qualifying individuals. The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each \$2,000 (or fraction thereof) of AGI above \$15,000. Thus, for taxpayers with adjusted gross income above \$43,000, the credit rate is 20 percent. The phase-out point and the amount of expenses eligible for the credit are not indexed for inflation.

Generally, a qualifying individual is: (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption, or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit.

Description of Proposal

The proposal repeals the credit for dependent care expenses.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Repeal of credit for adoption expenses (sec. 1302 of the discussion draft and sec. 23 of the Code)

Present Law

In general

A tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer subject to a maximum credit amount per eligible child.⁷² An eligible child is an individual who: (1) has not attained age 18; or (2) is physically or mentally incapable of caring for himself or herself. The maximum credit is applied per child rather than per year. Therefore, while

⁷² Sec. 36C.

qualified adoption expenses may be incurred in one or more taxable years, the tax credit per adoption of an eligible child may not exceed the maximum credit.

For taxable years beginning in 2014, the maximum credit amount is \$13,190, and the credit is phased out ratably for taxpayers with modified adjusted gross income (“AGI”) above a certain amount. In 2014, the phase out range begins at modified AGI of \$197,880, with no credit allowed for taxpayers with a modified AGI of \$237,880. Modified AGI is the sum of the taxpayer’s AGI plus amounts excluded from income under sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands and residents of Puerto Rico, respectively).

Special needs adoptions

In the case of a special needs adoption finalized during a taxable year, the taxpayer may claim as an adoption credit the amount of the maximum credit minus the aggregate qualified adoption expenses with respect to that adoption for all prior taxable years. A special needs child is an eligible child who is a citizen or resident of the United States whom a State has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child’s ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

Qualified adoption expenses

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of State or Federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child of the taxpayer’s spouse; and (4) not reimbursed (*e.g.*, by an employer).

Description of Proposal

The proposal repeals the credit for adoption expenses.

Effective Date

The proposal applies to amounts paid or incurred after December 31, 2014.

3. Nonbusiness energy property credit (sec.1303 of the discussion draft and sec. 25C of the Code)

Present Law

Credits in varying amounts are allowed through 2013 for certain (1) insulation, (2) energy efficient window, doors, skylights, and roofs, (3) advanced main air circulating fans, (4) natural gas, propane, or oil furnace or hot water boilers, (5) electric heat pump, natural gas, propane, or

oil water heaters, (6) central air conditions, or (7) wood stoves. The maximum total credit is \$500 for all taxable years.

Description of Proposal

The proposal repeals the nonbusiness energy property credit.

Effective Date

The proposal is effective for property placed in service after December 31, 2013.

4. Credit for residential energy efficient property (sec. 1304 of the discussion draft and sec. 25D of the Code)

Present Law

A thirty percent credit is available through 2016 for residential (1) solar water heating or solar electric property, (2) small wind property, (3) geothermal heat pump property, and (4) fuel cell property placed in service.

Description of Proposal

The proposal repeals the credit.

Effective Date

The proposal applies to property placed in service after December 31, 2014.

5. Repeal of credits for alternative fuel vehicles and alternative fuel refueling property (secs. 1305 through 1308 of the discussion draft and secs. 30, 30B, 30C, and 30D of the Code)

Present Law

Fuel cell vehicles (sec. 30B)

A credit is available through 2014 for new vehicles propelled by chemically combining oxygen with hydrogen and creating electricity. The base credit is \$4,000 for vehicles weighing 8,500 pounds or less. Heavier vehicles can get up to a \$40,000 credit, depending on their weight. An additional \$1,000 to \$4,000 credit is available to cars and light trucks to the extent their fuel economy exceeds the 2002 base fuel economy set forth in the Code.

Plug-in electric-drive motor vehicles (secs. 30 and 30D)

A credit is available for new four-wheeled vehicles (excluding low speed vehicles and vehicles weighing 14,000 pounds or more) propelled by a battery with at least 4 kilowatt-hours of electricity that can be charged from an external source. The base credit is \$2,500 plus \$417 for each kilowatt-hour of additional battery capacity in excess of 4 kilowatt-hours (for a

maximum credit of \$7,500). Qualified vehicles are subject to a 200,000 vehicle-per-manufacturer limitation.

A 10-percent credit up to \$2,500 is available for vehicles acquired before 2012 that otherwise qualify for the above credit but for the fact that they have limited speed. A similar 10-percent credit is available for two- and three-wheeled vehicles acquired before 2014 that have a battery capacity of at least 2.5 kilowatt-hours and are capable of achieving a speed of 45 miles per hour or greater. The 10-percent credits are not subject to the 200,000 vehicle-per-manufacturer limitation.

Credit for alternative fuel refueling property (sec. 30C)

A 30-percent credit is available through 2013 (2014 for hydrogen refueling property) for property that dispenses alternative fuels, including ethanol, biodiesel, natural gas, hydrogen, and electricity. The credit may not exceed \$30,000 per location for business property and \$1,000 for property installed at a principal residence.

Description of Proposal

The proposal repeals the credits for fuel cell and plug-in electric drive motor vehicles. The proposal also repeals the credit for alternative fuel refueling property.

Effective Date

For fuel cell vehicles, the proposal applies to property purchased after December 31, 2014. In the case of low speed plug-in electric vehicles, the proposal applies to vehicles acquired after December 31, 2011. For other plug-in electric vehicles, the proposal applies to vehicles acquired after December 31, 2014. For alternative fuel refueling property, the proposal applies to property placed in service after December 31, 2014.

6. Repeal of credit for health insurance costs of eligible individuals (sec. 1309 of the discussion draft and sec. 35 of the Code)

Present Law

In the case of an eligible individual, for months beginning before January 1, 2014, a refundable tax credit is provided for a portion (currently 72.5 percent) of the individual's premiums for qualified health insurance of the individual and qualifying family members⁷³ for each eligible coverage month beginning in the taxable year. The credit is commonly referred to as the health coverage tax credit ("HCTC"). The credit is available only with respect to amounts

⁷³ Qualifying family members are the individual's spouse and any dependent for whom the individual is entitled to claim a dependency exemption. Any individual who has certain specified coverage is not a qualifying family member.

paid by the individual and is available on an advance basis once a qualified health insurance costs credit eligibility certificate is in effect.⁷⁴

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if the month begins before January 1, 2014, and, as of the first day of the month, the individual (1) is an eligible individual, (2) is covered by qualified health insurance, (3) does not have other specified coverage, and (4) is not imprisoned under Federal, State, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements.

An eligible individual is an individual who is (1) an eligible Trade Adjustment Assistance (“TAA”) recipient, (2) an eligible alternative TAA recipient, or (3) an eligible Pension Benefit Guaranty Corporation (“PBGC”) pension recipient. In general, an individual is an eligible TAA recipient for a month if the individual (1) receives for any day of the month a trade readjustment allowance under the Trade Act of 1974 or would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment benefits before being eligible to receive an allowance and (2) with respect to such allowance, is covered under a required certification.⁷⁵ An individual is an eligible alternative TAA recipient for a month if the individual participates in a certain program under the Trade Act of 1974 and receives a related benefit for the month. Generally, an individual is a PBGC pension recipient for any month if the individual (1) is age 55 or over as of the first day of the month and (2) receives a benefit, any portion of which is paid by the PBGC. A person who may be claimed as a dependent on another person’s tax return is not an eligible individual. In addition, an otherwise eligible individual is not eligible for the credit for a month if, as of the first day of the month, the individual has certain specified coverage, such as certain employer-provided coverage or coverage under certain governmental health programs.

Description of Proposal

The proposal repeals the health coverage tax credit in accordance with expiration of the credit for months beginning after December 31, 2013.

Effective Date

The proposal is effective for months beginning after December 31, 2013.

⁷⁴ Sec. 7527.

⁷⁵ The eligibility rules and conditions for such a trade readjustment allowance are specified in chapter 2 of title II of the Trade Act of 1974. Among other requirements, payment of a trade readjustment allowance is conditioned on the individual enrolling in certain training programs or receiving a waiver of training requirements. The required certification is issued under subchapter A or D of chapter 2 of title II of the Trade Act of 1974.

7. Repeal of first time homebuyer credit (sec. 1310 of the discussion draft and sec. 36 of the Code)

Present and Prior Law

Under present law, there is no credit for the purchase of a home. Prior law provided an individual who is a first-time homebuyer a refundable tax credit equal up to a maximum of \$8,000 (\$4,000 for a married individual filing separately) or 10 percent of the purchase price of a principal residence purchased after April 9, 2008. The credit expired for purchases after July 1, 2010 (July 1, 2011 for certain individuals on qualified official extended duty outside of the United States).

Description of Proposal

The proposal repeals section the first time homebuyer credit. Credit recapture provisions continue to apply to residences purchased before July 1, 2011.

Effective Date

The proposal applies to residences purchased after June 30, 2011.

E. Deductions, Exclusions, and Certain Other Provisions

1. Exclusion of gain from sale of a principal residence (sec. 1401 of the discussion draft and sec. 121 of the Code)

Present Law

A taxpayer who is an individual may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances, is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

The exclusion under this provision may not be claimed for more than one sale or exchange during any two-year period.

Description of Proposal

The proposal extends the length of time a taxpayer must own and use a residence to qualify for this exclusion. Specifically, the exclusion is available only if the taxpayer has owned and used the residence as a principal residence for at least five of the eight years ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the five years that the ownership and use requirements are met.

The proposal limits the exclusion so that the exclusion may not apply to more than one sale or exchange during any five-year period.

The proposal phases-out the exclusion by one dollar for every dollar a taxpayer's AGI exceeds \$250,000 (\$500,000 if married filing a joint return).

Effective Date

The proposal applies to sales and exchanges after December 31, 2014.

2. Mortgage interest (sec. 1402 of the discussion draft and sec. 163 of the Code)

Present Law

As a general matter, personal interest is not deductible.⁷⁶ Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.⁷⁷ Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition indebtedness

Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing or substantially improving a qualified residence of the taxpayer and which secures the residence. The maximum amount treated as acquisition indebtedness is \$1 million (\$500,000 in the case of a married person filing a separate return).

Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness. Thus, for example, if the taxpayer incurs \$200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to \$150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above \$150,000 (except by indebtedness incurred to substantially improve the residence).

Interest on acquisition indebtedness is allowable in computing alternative minimum taxable income. However, in the case of a second residence, the acquisition indebtedness may only be incurred with respect to a house, apartment, condominium, or a mobile home that is not used on a transient basis.

Home equity indebtedness

Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence.

The amount of home equity indebtedness may not exceed \$100,000 (\$50,000 in the case of a married individual filing a separate return) and may not exceed the fair market value of the residence reduced by the acquisition indebtedness.

Interest on home equity indebtedness is not deductible in computing alternative minimum taxable income.

⁷⁶ Sec. 163(h)(1).

⁷⁷ Sec. 163(h)(2)(D) and (h)(3).

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer's family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (e.g., a traditional mortgage), a series of payments (e.g., a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (e.g., a home equity line of credit).

Thus, the aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is \$1,100,000 (\$550,000, for married persons filing a separate return).

Reporting requirements

Any person who, in the course of a trade or business during a calendar year, received from an individual \$600 or more of interest during a calendar year on an obligation secured by real property (such as mortgage interest) must file an information return with the IRS and must provide a copy of that return to the payor. The information return generally must include the name, address, and taxpayer identification number of the individual from whom the interest was received, and the amount of the interest and points received for the calendar year.

Description of Proposal

The proposal modifies the limitations on the amount of indebtedness that may be treated as acquisition indebtedness with respect to which interest payments are deductible. The proposal is phased in. The maximum amount of indebtedness treated as acquisition indebtedness incurred in 2015 is \$875,000; in 2016 is \$750,000; in 2017 is \$625,000; and in 2018 and thereafter, is \$500,000. In the case of a married person filing a separate return the maximum amounts are half these amounts.

Under the proposal, interest paid on home equity indebtedness incurred after 2014 is not treated as qualified residence interest, and thus is not deductible.

The proposal does not change the treatment of interest on qualified residence indebtedness incurred before 2015.

Special rules apply in the case of indebtedness from refinancing existing qualified residence indebtedness. Specifically, present law continues to apply to any indebtedness incurred on or after January 1, 2015, to refinance qualified residence indebtedness incurred before that date to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness. Thus, the maximum dollar amount that may be treated as qualified indebtedness will not decrease by reason of a refinancing.

The proposal modifies the reporting requirements with respect to taxpayers who, in the course of a trade or business during a calendar year, received from an individual \$600 or more of interest during a calendar year on an obligation secured by real property (such as mortgage

interest). In addition to the present-law reporting requirements, the proposal requires that taxpayers report both the amount of outstanding principal on the mortgage as of the beginning of the calendar year and the date of origination of the mortgage.

Effective Date

The modification of the limitations on the deductibility of interest applies to interest paid or accrued on indebtedness incurred after December 31, 2014. The modification of the reporting requirements applies to returns and statements for calendar years after 2014.

3. Charitable contributions (sec. 1403 of the discussion draft and sec. 170 of the Code)

Present Law

In general

The Internal Revenue Code allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local and Indian tribal governments, and certain other organizations.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.⁷⁸ Fourth, the transfer must be of money or property—contributions of services are not deductible.⁷⁹ Finally, the transfer must be substantiated and in the proper form.

As also discussed below, special rules limit a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

⁷⁸ Sec. 170(a)(1).

⁷⁹ For example, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

Contributions of partial interests in property

In general

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.⁸⁰ This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.⁸¹ For this purpose, a future interest is one “in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property.”⁸²

A gift of an undivided portion of a donor’s entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.⁸³ For this purpose, an undivided portion of a donor’s entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor’s interest in such property.⁸⁴ A gift generally is treated as a gift of an undivided portion of a donor’s entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.⁸⁵

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed

⁸⁰ Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

⁸¹ Sec. 170(a)(3).

⁸² Treas. Reg. sec. 1.170A-5(a)(4). Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has “no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year.” Treas. Reg. sec. 1.170A-5(a)(2).

⁸³ Sec. 170(f)(3)(B)(ii).

⁸⁴ Treas. Reg. sec. 1.170A-7(b)(1).

⁸⁵ Treas. Reg. sec. 1.170A-7(b)(1).

percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified conservation contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.⁸⁶ A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. 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 (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. 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.

Percentage limits on charitable contributions

Individual taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's adjusted gross income ("AGI") for a taxable year, disregarding any net operating loss carryback to the year under section 172.⁸⁷ In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

⁸⁶ Secs. 170(f)(3)(B)(iii) and 170(h).

⁸⁷ Sec. 170(b)(1)(G).

Contributions of appreciated capital gain property to public charities and other organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, more favorable percentage limits sometimes apply to contributions to the donee charity than to contributions that are for the use of the donee charity. Contributions of capital gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base.⁸⁸ In contrast to property contributed directly to a charitable organization, property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.⁸⁹ Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

⁸⁸ Under a special, temporary provision that was effective for contributions made in taxable years beginning before January 1, 2014, certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

⁸⁹ *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).

Table 2.—Charitable Contribution Percentage Limits For Individual Taxpayers⁹⁰

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient ⁹¹	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30% ⁹²	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.⁹³ For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.⁹⁴

Carryforwards of excess contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.⁹⁵ In general, contributions carried over from a prior year are

⁹⁰ Percentages shown are the percentage of an individual's contribution base.

⁹¹ Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

⁹² Under a special, temporary provision that was effective for contributions made in taxable years beginning before January 1, 2014, certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.

⁹³ Sec. 170(b)(2)(A).

⁹⁴ Sec. 170(b)(2)(C). Under a special, temporary provision, certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

⁹⁵ Sec. 170(d).

taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Temporary rule for qualified conservation contributions

Under a temporary provision that was effective for contributions made in taxable years beginning before January 1, 2014,⁹⁶ preferential percentage limits and carryforward rules apply for qualified conservation contributions. In general, under the temporary provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.⁹⁷

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Valuation of charitable contributions

In general

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair

⁹⁶ Sec. 170(b)(1)(E).

⁹⁷ Sec. 170(b)(2)(B).

market value of long-term capital gain property contributed to charity.⁹⁸ Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;⁹⁹ (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;¹⁰⁰ and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).¹⁰¹

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.¹⁰² Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.¹⁰³ A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.¹⁰⁴

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

⁹⁸ Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Sec. 170(e)(1)(A).

⁹⁹ Sec. 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.

¹⁰⁰ Sec. 170(e)(1)(B)(i)(I).

¹⁰¹ Sec. 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. Sec. 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.

¹⁰² Sec. 170(e)(5).

¹⁰³ Sec. 170(e)(5)(B).

¹⁰⁴ Sec. 170(e)(5)(C).

Enhanced deduction rules for certain contributions of inventory and other property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.*, basis plus one-half of fair market value in excess of basis) or (2) two times basis.¹⁰⁵ To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.¹⁰⁶ Contributions to organizations that are not described in section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Under a temporary provision that was effective for contributions made before January 1, 2014, any taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.¹⁰⁷ Another expired provision (effective for contributions made before January 1, 2012) allowed an enhanced charitable deduction for certain contributions of book inventory.¹⁰⁸

Selected statutory rules for specific types of contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report – and in many instances overstated – the value of the property for purposes of claiming a charitable deduction.

¹⁰⁵ Sec. 170(e)(3).

¹⁰⁶ Sec. 170(e)(3)(A)(i)-(iii).

¹⁰⁷ Sec. 170(e)(3)(C).

¹⁰⁸ Sec. 170(e)(3)(D).

Vehicles.—Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds \$500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and other intellectual property.—If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory)¹⁰⁹ to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.¹¹⁰ In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).¹¹¹

Clothing and household items.—Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than \$500 may be deducted if the taxpayer

¹⁰⁹ Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See sec. 1221(a)(3), 1231(b)(1)(C).

¹¹⁰ Sec. 170(e)(1)(B)(iii).

¹¹¹ The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

includes with the taxpayer's return a qualified appraisal with respect to the property.¹¹² Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.¹¹³

College athletic seating rights.—In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. However, special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. Specifically, the payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in section 3304(f)) described in section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.¹¹⁴

Description of Proposal

The proposal makes the following modifications to present law.

Two-percent floor on charitable deduction for individuals

The proposal imposes a two-percent floor on charitable contributions by taxpayers who are individuals. Specifically, the amount of an individual's charitable contributions for a taxable year (determined without regard to excess contributions carried over from a prior year under section 170(d)) are reduced by two percent of the taxpayer's contribution base for the taxable year.

The two-percent reduction is applied in the following order: (1) first, to charitable contributions to which paragraph 170(b)(1)(B) applies (generally, contributions subject to a 25-percent limitation, as reduced under the proposal); (2) second, to qualified conservation contributions; and (3) third, to charitable contributions to which paragraph 170(b)(1)(A) applies (generally, other contributions subject to a 40-percent limitation, as reduced under the proposal).

¹¹² As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than \$5,000.

¹¹³ The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

¹¹⁴ Sec. 170(l).

Extension of time for individuals to make charitable contributions

The proposal permits individuals to elect to deduct for a taxable year charitable contributions made after the close of the taxable year but not later than the due date (determined without regard to extensions) for the individual's income tax return for the taxable year. The election must be made at the time of the filing of the tax return in the manner provided by the Secretary. For example, if a calendar year taxpayer makes a charitable contribution on February 15, 2015, the individual may elect to treat the contribution as having been made during 2014. The election must be made at the time of the filing of the 2014 income tax return in the manner prescribed by the Secretary.

Deduction for contributions of appreciated property generally limited to basis

Under the proposal a charitable contribution of property generally is reduced by the amount of gain that would have been realized if the property contributed had been sold by the taxpayer for its fair market value (determined at the time of the contribution). In other words, the proposal generally limits a charitable contribution of appreciated property to the taxpayer's basis in the property.

The proposal provides that contributions of certain property are reduced only by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market (determined at the time of the contribution). In other words, the amount of such contributions of property need only be reduced by the amount of any short-term capital gain or ordinary income, resulting in more preferential treatment for such property relative to other property under the proposal. These contributions include:

1. Contributions of tangible personal property if the use of the property by the donee organization is related to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in section 170(c));
2. Qualified conservation contributions described in section 170(h)(1);
3. Contributions of inventory and similar property that qualify for an enhanced charitable contribution deduction under present law¹¹⁵;
4. Contributions of scientific property used for research that qualify for an enhanced deduction under present law¹¹⁶; and

¹¹⁵ Sec. 170(e)(3). The proposal repeals the expired provisions that provided an enhanced deduction for certain contributions of food and book inventory.

¹¹⁶ Sec. 170(e)(4).

5. Contributions of qualified appreciated stock (generally limited to 10 percent of the outstanding stock of a corporation), as described in present-law sections 170(e)(5)(B) and (C), to an organization described in section 170(c).

The special rules of present law continue to apply in determining whether the sale of certain property would result in a long-term gain.

Modifications to income-based percentage limits and repeal of separate, lower percentage limits for contributions of capital gain property

The proposal reduces the income-based percentage limit described in section 170(b)(1)(A) for certain charitable contributions by an individual taxpayer of cash and property that is not appreciated to public charities and certain other organizations from 50 percent to 40 percent. The proposal reduces the percentage limit for certain charitable contributions by an individual taxpayer to nonoperating private foundations from 30 percent to 25 percent.

The proposal repeals the provisions that provide lower percentage limitations on contributions of capital gain property (section 170(b)(1)(C), which generally imposes a 30-percent limit on charitable contributions of capital gain property to public charities and certain other organizations, and 170(b)(1)(D), which generally imposes a 20-percent limit on charitable contributions of capital gain property to nonoperating private foundations and certain other organizations). Thus, all contributions generally qualify for the more preferential 40- and 25-percent limitations, respectively, of sections 170(b)(1)(A) and 170(b)(1)(B), as amended.

Qualified conservation contributions

The proposal extends and makes permanent the special rules for qualified conservation contributions that provide for increased charitable contribution percentage limits and extended carryforward periods for excess contributions.

Golf course easements

The proposal modifies the definition of a qualified real property interest that may be treated as a qualified conservation contribution under section 170(h) generally to exclude golf course property. Specifically, an interest in real property is not treated as a qualified real property interest if (at the time of the contribution of such interest) the property is, or is intended to be, used as a golf course. As a result, charitable contributions of conservation easements on golf course property will not: (1) be excepted from the “partial interest” rule that generally denies a charitable deduction for a contribution of a partial interest in property, and (2) qualify for the preferential percentage limit and carryforward rules that generally apply to qualified conservation contributions.

College athletic event seating rights

The proposal repeals section 170(l), which generally provides that a taxpayer may deduct 80 percent of certain payments to institutions of higher education in exchange for which the taxpayer receives the right to purchase tickets or seating at an athletic event of such an institution.

Contributions of intellectual property

The proposal repeals section 170(m), under which certain donee income from intellectual property is treated as an additional charitable contribution.

Effective Date

The proposal generally is effective for contributions made in taxable years beginning after December 31, 2014.

The permanent extension of the special rules for qualified conservation contributions is effective for contributions made in taxable years beginning after December 31, 2013.

4. Denial of deduction for expenses attributable to the trade or business of being an employee (sec. 1404 of the discussion draft and sec. 62(a)(2) and new sec. 262A of the Code)

Present Law

In general, business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.¹¹⁷ However, in the case of certain employees and certain expenses, a deduction may be taken in determining adjusted gross income (referred to as an “above-the-line” deduction), including expenses of qualified performing artists, expenses of State or local government officials performing services on a fee basis, expenses of eligible educators (applicable under present law for taxable years beginning after 2001 and before 2014), and expenses of members of a reserve component of the Armed Forces.¹¹⁸

A working condition fringe provided to an employee is excluded from the employee’s income and wages.¹¹⁹ For this purpose, a working condition fringe means property or services provided to an employee to the extent that, if the employee paid for the property or service, the payment would be deductible as a business expense or depreciation.

Description of Proposal

Under the proposal, business expenses incurred by an employee are not deductible, other than expenses that are deductible in determining adjusted gross income (that is, above-the-line deductions). In addition, the proposal repeals the provisions allowing above-the-line deductions for expenses of qualified performing artists and expenses of State or local government officials performing services on a fee basis. The proposal also repeals the provision allowing an above-the-line deduction for expenses of eligible educators for taxable years beginning after 2001 and

¹¹⁷ Secs. 62(a)(1) and 67.

¹¹⁸ Sec. 62(a)(2)(B), (C), (D) and (E). Under section 62(a)(2)(A) and (c), certain reimbursements of employee business expenses are excluded from income.

¹¹⁹ Sec. 132(a)(3) and (d).

before 2014.¹²⁰ The proposal retains the provision allowing an above-the-line deduction for expenses of members of a reserve component of the Armed Forces.¹²¹ In addition, whether property or services provided by an employer are excluded as a working condition fringe is determined without regard to the proposal, that is, the same standard as under present law applies for this purpose.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

5. Repeal of deduction for taxes not paid or accrued in a trade or business (sec. 1405 of the discussion draft and sec. 164 of the Code)

Present Law

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are: (i) State, local real and foreign property taxes;¹²² (ii) State and local personal property taxes;¹²³ (iii) State, local and foreign income, war profits, and excess profits taxes.¹²⁴ For taxable years beginning before 2014, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.¹²⁵

Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.¹²⁶

¹²⁰ As under present law, this provision does not apply for taxable years beginning in 2014.

¹²¹ The proposal also retains the provision under which certain reimbursements of employee business expenses are excluded from income.

¹²² Sec. 164(a)(1).

¹²³ Sec. 164(a)(2).

¹²⁴ Sec. 164(a)(3). A foreign tax credit, in lieu of a deduction, is allowable for foreign taxes if the taxpayer so elects.

¹²⁵ Sec. 164(b)(5).

¹²⁶ See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78th Cong., 2d. Sess.), reprinted at 19 C. B. 839 (1944).

Individuals also are permitted a deduction for Federal and State generation skipping transfer tax ("GST tax") imposed on certain income distributions that are included in the gross income of the distributee.¹²⁷

In determining a taxpayer's alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.

Description of Proposal

The proposal provides that in the case of an individual, State, local and foreign property taxes shall be allowed as a deduction only when paid or accrued in carrying on a trade or business or an activity described in section 212 (relating to expenses for the production of income).¹²⁸

The proposal also provides that in the case of an individual, State and local income, war profits, and excess profits taxes are not allowable as a deduction.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

6. Repeal of deduction for personal casualty losses (sec. 1406 of the discussion draft and sec. 165 of the Code)

Present Law

A taxpayer may generally claim a deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.¹²⁹ Personal casualty or theft losses are deductible only if they exceed \$100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

Description of Proposal

The proposal repeals the deduction for personal casualty losses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

¹²⁷ Sec. 164(a)(4).

¹²⁸ The proposal does not modify the deductibility of GST tax imposed on certain income distributions.

¹²⁹ Sec. 165(c).

7. Limitation on wagering losses (sec. 1407 of the discussion draft and sec. 165(d) of the Code)

Present Law

Losses sustained during the taxable year on wagering transactions are allowed as a deduction only to the extent of the gains during the taxable year from such transactions.¹³⁰

Description of Proposal

The proposal clarifies the scope of “losses from wagering transactions” as that term is used in section 165(d). The proposal provides that this term includes any deduction otherwise allowable under chapter 1 of the Code incurred in carrying on any wagering transaction.

The proposal is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but to other expenses incurred by the individual in connection with the conduct of that individual’s gambling activity.¹³¹ The proposal clarifies, for instance, an individual’s otherwise deductible expenses in traveling to or from a casino are subject to the limitation under section 165(d).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

8. Repeal of deduction for tax preparation expenses (sec. 1408 of the discussion draft and sec. 212 of the Code)

Present Law

For regular income tax purposes, individuals are allowed an itemized deduction for expenses for the production of income. These expenses are defined as ordinary and necessary expenses paid or incurred in a taxable year: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.¹³²

¹³⁰ Sec. 165(d).

¹³¹ The proposal thus reverses the result reached by the Tax Court in *Ronald A. Mayo v. Commissioner*, 136 T.C. 81 (2011). In that case, the Court held that a taxpayer’s expenses incurred in the conduct of the trade or business of gambling, other than the cost of wagers, were not limited by sec. 165(d), and were thus deductible under sec. 162(a).

¹³² Sec. 212.

Description of Proposal

The proposal repeals the deduction for expenses in connection with the determination, collection, or refund of any tax. Expenses in the other two categories are not changed by the proposal.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

9. Repeal of deduction for medical expenses (sec. 1409 of the discussion draft and sec. 213 of the Code)

Present Law

Individuals are allowed an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 10 percent of adjusted gross income. However, for the years 2013, 2014, 2015 and 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the taxable year, the threshold is at 7.5 percent of adjusted gross income.

Description of Proposal

The proposal repeals the itemized deduction for unreimbursed medical expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

10. Repeal of the disqualification of expenses for over-the-counter drugs under certain accounts and arrangements (sec. 1410 of the discussion draft and secs. 106 and 223 of the Code)

Present Law

Individual deduction for medical expenses

Expenses for medical care, not compensated for by insurance or otherwise, are deductible by an individual under the rules relating to itemized deductions to the extent the expenses exceed 10 percent of adjusted gross income ("AGI").¹³³ Medical care generally is defined broadly as

¹³³ Sec. 213(a). For taxable years beginning before January 1, 2013, the threshold was 7.5 percent of AGI. However, the increase in the threshold from 7.5 to 10 percent of AGI does not apply until taxable years beginning after December 31, 2016, with respect to any taxpayer if the taxpayer or the taxpayer's spouse has attained age 65 before the close of the taxable year.

amounts paid for diagnoses, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body.¹³⁴

Under an explicit limitation, any amount paid during a taxable year for medicine or drugs is deductible as a medical expense only if the medicine or drug is a prescribed drug or insulin.¹³⁵ The term prescribed drug means a drug or biological which requires a prescription of a physician for its use by an individual.¹³⁶ Thus, any amount paid for medicine available without a prescription (“over-the-counter medicine”) is not deductible as a medical expense, including any medicine prescribed or recommended by a physician.¹³⁷

Exclusion for employer-provided health care

Employees are not taxed on (that is, may exclude from gross income) the value of employer-provided health coverage under an accident or health plan.¹³⁸ In addition, any reimbursements under an employer-provided accident or health plan for medical care expenses for employees, their spouses, their dependents, and adult children under age 27 generally are excludible from gross income.¹³⁹ An employer may agree to reimburse expenses for medical care of its employees (and their spouses and dependents), not covered by a health insurance plan, through a flexible spending arrangement (“FSA”) which allows reimbursement not in excess of a specified dollar amount. The amounts available for reimbursement must be exclusively for reimbursement for medical care because the exclusion does not apply to amounts to which the employee would be entitled irrespective of whether he or she incurs expenses for medical care.¹⁴⁰

Such dollar amount is either elected by an employee under a cafeteria plan (“Health FSA”) or otherwise specified by the employer under a health reimbursement arrangement (“HRA”). Reimbursements under these arrangements are also excludible from gross income as reimbursements for medical care under employer-provided health coverage.

Health savings accounts

An individual with a high deductible health plan (and no other health plan other than a plan that provides certain permitted insurance or permitted coverage) may establish a health

¹³⁴ Sec. 213(d). There are certain limitations on the general definition including a rule that cosmetic surgery or similar procedures are generally not medical care.

¹³⁵ Sec. 213(b).

¹³⁶ Sec. 213(d)(3).

¹³⁷ Rev. Rul. 2003-58, 2003-1 CB 959.

¹³⁸ Sec 106.

¹³⁹ Sec. 105(b).

¹⁴⁰ Treas. Reg. sec. 1.105-2.

savings account (“HSA”). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Thus, earnings on amounts in HSAs are not taxable.

Subject to limits,¹⁴¹ contributions made to an HSA by an employer, including contributions made through a cafeteria plan through salary reduction, are excludible from income (and from wages for payroll tax purposes). Contributions made by individuals are deductible for income tax purposes, regardless of whether the individuals itemize. Distributions from an HSA that are used for qualified medical expenses are excludible from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 20 percent. The 20-percent additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). Similar rules apply for another type of medical savings arrangement called an Archer medical savings account (“Archer MSA”).¹⁴²

Medical care for excludible reimbursements

For purposes of the exclusion for reimbursements under employer-provided accident and health plans (including under Health FSAs and HRAs), and for distributions from HSAs and Archer MSAs used for qualified medical expenses, the definition of medical care is generally the same as the definition that applies for the itemized deduction for the cost of medical care. However, prior to the enactment of the Patient Protection and Affordable Care Act (referred to as the “Affordable Care Act”),¹⁴³ the limitation (applicable to the itemized deduction) that only prescription medicines or drugs and insulin are taken into account did not apply. Thus, for example, amounts paid from a Health FSA or HRA, or funds distributed from an HSA to reimburse a taxpayer for nonprescription drugs, such as nonprescription aspirin, allergy medicine, antacids, or pain relievers, were excludible from income even though, if the taxpayer paid for such amounts directly (without such reimbursement), the expenses could not be taken into account in determining the itemized deduction for medical expenses.¹⁴⁴

For years beginning after December 31, 2010, the Affordable Care Act changed the definition of medical care for purposes of the exclusion for reimbursements for medical care

¹⁴¹ For 2014, the maximum aggregate annual contribution that can be made to an HSA is \$3,300 in the case of self-only coverage and \$6,550 in the case of family coverage. The annual contribution limits are increased by \$1,000 for individuals who have attained age 55 by the end of the taxable year (referred to as “catch-up contributions”). Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

¹⁴² Sec. 220.

¹⁴³ Pub. L. No 111-148. Various provisions of the Affordable Care Act are amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152.

¹⁴⁴ Rev. Rul. 2003-102, 2993-2 C.B. 559, now obsolete by Rev. Rul. 2010-23, 2010-39 I.R.B. 388.

under employer-provided accident and health plans and for distributions from HSAs and Archer MSAs used for qualified medical expenses to require that over-the-counter medicine (other than insulin) be prescribed by a physician in order for the medicine to be medical care for these purposes.¹⁴⁵ Thus, under present law, a Health FSA or an HRA is only permitted to reimburse an employee for the cost of over-the-counter medicine if the medicine is prescribed by a physician and distributions from an HSA or an Archer MSA used to purchase over-the-counter medicine is not a qualified medical expense unless the medicine is prescribed by a physician.

Description of Proposal

The proposal repeals the change to the definition of medical care made by the Affordable Care Act for purposes of the exclusion for reimbursements for medical care under employer-provided accident and health plans and for distributions from HSAs or Archer MSAs used for qualified medical expenses that requires that over-the-counter medicine (other than insulin) be prescribed by a physician in order for the medicine to be medical care for these purposes. Thus, for example, amounts paid from a Health FSA or HRA, or funds distributed from an HSA or an Archer MSA to reimburse a taxpayer for nonprescription drugs, such as nonprescription aspirin, allergy medicine, antacids, or pain relievers, are excludible from income.

Effective Date

The proposal is effective with respect to expenses incurred after December 31, 2014.

11. Repeal of deduction for alimony payments and corresponding inclusion in gross income (sec. 1411 of the discussion draft and secs. 71 and 215 of the Code)

Present Law

Alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse.¹⁴⁶ Child support payments are not treated as alimony.¹⁴⁷

Description of Proposal

Under the proposal, alimony and separate maintenance payments are not deductible by the payor spouse. The proposal repeals sections 61(a)(8) and 71 of the Code. Those sections specified that alimony and separate maintenance payments are included in income. Thus, the intent of the proposal is to follow the rule of the Supreme Court's holding in *Gould v. Gould*,¹⁴⁸

¹⁴⁵ Sec. 9003 of the Affordable Care Act. Notice 2010-59, 2010-39 I.R.B. 388, provides guidance on this change to the definition of medical care for these purposes.

¹⁴⁶ Secs. 215(a) and 71(a).

¹⁴⁷ Sec. 71(c).

¹⁴⁸ 245 U.S. 151 (1917).

in which the Court held that such payments are not income to the recipient. The treatment of child support is not changed.

Effective Date

The proposal is effective for any divorce or separation instrument executed after December 31, 2014, or for any divorce or separation instrument executed on or before December 31, 2014, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.

12. Repeal of deduction for moving expenses (sec. 1412 of the discussion draft and sec. 217 of the Code)

Present Law

Individuals are allowed an itemized deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work.¹⁴⁹ Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

Description of Proposal

The proposal repeals the deduction for moving expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

13. Termination of deduction and exclusions for contributions to medical savings accounts (sec. 1413 of the discussion draft and secs. 106(b) and 220 of the Code)

Present Law

Archer MSAs

As of 1997, certain individuals are permitted to contribute to an Archer MSA, which is a tax-exempt trust or custodial account.¹⁵⁰ Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an individual.

¹⁴⁹ Sec. 217(a).

¹⁵⁰ Archer MSAs were originally called medical savings accounts or MSAs.

An individual is generally eligible for an Archer MSA if the individual is covered by a high deductible health plan and no other health plan other than a plan that provides certain permitted insurance or permitted coverage. In addition, the individual either must be an employee of a small employer (generally an employer with 50 or fewer employees on average) that provides the high deductible health plan or must be self-employed or the spouse of a self-employed individual and the high deductible health plan is not provided by the employer of the individual or spouse.

For 2014, a high deductible health plan for purposes of Archer MSA eligibility is a health plan with an annual deductible of at least \$2,200 and not more than \$3,250 in the case of self-only coverage and at least \$4,350 and not more than \$6,550 in the case of family coverage. In addition, for 2014, the maximum out-of-pocket expenses with respect to allowed costs must be no more than \$4,350 in the case of self-only coverage and no more than \$8,000 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan does not fail to qualify as a high deductible health plan if substantially all of the coverage under the plan is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the annual deductible under the individual's high deductible health plan in the case of self-only coverage (65 percent of \$3,250 for 2014) and 75 percent of the annual deductible in the case of family coverage (75 percent of \$6,550 for 2014), but in no case more than the individual's compensation income. In addition, the maximum contribution can be made only if the individual is covered by the high deductible health plan for the full year.

Distributions from an Archer MSA for qualified medical expenses are not includible in gross income. Distributions not used for qualified medical expenses are includible in gross income and subject to an additional 20-percent tax unless an exception applies. A distribution from an Archer MSA may be rolled over on a nontaxable basis to another Archer MSA or to a health savings account and does not count against the contribution limits.

After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had made Archer MSA contributions and employees of small employers that previously contributed to Archer MSAs (or at least 20 percent of whose employees who were previously eligible to contribute to Archer MSAs did so).

Health savings accounts

As of 2004, an individual with a high deductible health plan (and no other health plan other than a plan that provides certain permitted insurance or permitted coverage) generally may contribute to a health savings account ("HSA"), which is a tax-exempt trust or custodial account. HSAs provide similar tax-favored savings treatment as Archer MSAs. That is, within limits, contributions to an HSA are deductible in determining adjusted gross income if made by an individual and are excludable from gross income and wages for employment tax purposes if

made by the employer of an individual, and distributions for qualified medical expenses are not includible in gross income.¹⁵¹ However, the rules for HSAs are in various aspects more favorable than the rules for Archer MSAs. For example, the availability of HSAs is not limited to employees of small employers or self-employed individuals and their spouses.

For 2014, a high deductible health plan for purposes of HSA eligibility is a health plan with an annual deductible of at least \$1,250 in the case of self-only coverage and at least \$2,500 in the case of family coverage. In addition, for 2013, the sum of the deductible and the maximum out-of-pocket expenses with respect to allowed costs must be no more than \$6,350 in the case of self-only coverage and no more than \$12,700 in the case of family coverage. A plan does not fail to qualify as a high deductible health plan for HSA purposes merely because it does not have a deductible for preventive care.

For 2014, the maximum aggregate annual contribution that can be made to an HSA is \$3,300 in the case of self-only coverage and \$6,550 in the case of family coverage. The annual contribution limits are increased by \$1,000 for individuals who have attained age 55 by the end of the taxable year (referred to as “catch-up contributions”). The maximum amount that an individual make contribute is reduced by the amount of any contributions to the individual’s Archer MSA and any excludable HSA contributions made by the individual’s employer. In some cases, an individual may make the maximum HSA contribution, even if the individual is covered by the high deductible health plan for only part of the year. A distribution from an HSA may be rolled over on a nontaxable basis to another HSA and does not count against the contribution limits.

Description of Proposal

Under the proposal, contributions to Archer MSAs for taxable years beginning after December 31, 2014, are not deductible or excluded from income and wages.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

14. Repeal of two-percent floor on miscellaneous itemized deductions (sec. 1414 of the discussion draft and sec. 67 of the Code)

Present Law

An individual may claim an itemized deduction for certain miscellaneous expenses only to the extent of such expenses in excess of two percent of the taxpayer’s adjusted gross income.¹⁵² Miscellaneous expenses subject to the two-percent floor include certain unreimbursed employee business expenses and expenses for the production or collection of

¹⁵¹ Secs. 106(d) and 223.

¹⁵² Sec. 67(a).

income, for the management, conservation, or maintenance of property held for the production of income, and in connection with the determination, collection, or refund or any tax.

To be deductible, an unreimbursed employee business expense must be: (1) paid or incurred during the taxable year; (2) for carrying on the trade or business of being an employee; and (3) an ordinary and necessary business expense. Thus, unreimbursed employee business expenses are those expenses that would be deductible above the line if the employee were engaged in a trade or business (other than the trade or business of being an employee). Generally, the two-percent floor applies to unreimbursed employee business expenses after any other deduction limit (such as the 50-percent limit on expenses for business-related meals and entertainment). Unreimbursed employee expenses include such expenses as certain business and professional dues, uniform costs, home office deductions, business bad debts of an employee, employment related education expenses, licenses and regulatory fees, malpractice insurance premiums, medical examinations required by an employer, occupational taxes, publications and subscriptions, job search, employment and outplacement agency fees, and union dues and expenses.

The two-percent floor does not apply to the following itemized deductions: (1) otherwise deductible interest; (2) State and local income (or in lieu of such, State sales), real property, and certain personal property taxes; (3) casualty and theft losses; (4) gambling losses to the extent of gambling winnings; (5) charitable contributions; (6) medical expenses; (7) impairment-related work expenses of a disabled individual; (8) the estate tax on income in respect to a decedent; (9) any deduction allowable in connection with personal property used in a short sale; (10) certain adjustments occurring when a taxpayer restores amounts held under a claim of right; (11) amortizable bond premium; (12) certain terminated annuity payments; and (13) deductions in connection with cooperative housing corporations. The two-percent floor does not apply to deductions allowable to estates or trusts under sections 642(c), 651, and 661.

Description of Proposal

The proposal repeals the two-percent floor on miscellaneous itemized deductions.¹⁵³

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

¹⁵³ The proposal repeals certain miscellaneous itemized deductions. See sec. 1404 (repeal of deduction for expenses attributable to the trade or business of being an employee), and sec. 1408 (repeal of deduction for tax preparation expenses).

15. Repeal of overall limitation on itemized deductions (sec. 1415 of the discussion draft and sec. 68 of the Code)

Present Law

The total amount of most otherwise allowable itemized deductions (other than the deductions for medical expenses, investment interest and casualty, theft or gambling losses) is limited for certain upper-income taxpayers.¹⁵⁴ All other limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced by three percent of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount.

For 2014, the threshold amounts are \$254,200 for single taxpayers, \$279,650 for heads of household, \$305,050 for married couples filing jointly, and \$152,525 for married taxpayers filing separately. These threshold amounts are indexed for inflation. The otherwise allowable itemized deductions may not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

Description of Proposal

The proposal repeals the overall limitation on itemized deductions.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

16. Deduction for amortizable bond premium allowed in determining adjusted gross income (sec. 1416 of the discussion draft and sec. 62 of the Code)

Present Law

Under present law, a deduction for amortizable bond premium is allowed to the holder of a taxable bond acquired for more than the amount payable on maturity.¹⁵⁵ The deduction is an itemized deduction.¹⁵⁶ The amount amortizable is computed on a constant yield basis. The amount of bond premium is allocated among the interest payments received on the bond, and the allocated amount reduces the amount of the interest payments to the extent thereof, in lieu of any deduction otherwise allowable.¹⁵⁷

¹⁵⁴ Sec. 68.

¹⁵⁵ Sec. 171(a)(1).

¹⁵⁶ Sec. 62.

¹⁵⁷ See Treas. Reg. sec. 1.171-2 for rules relating to offsetting qualified stated interest with premium.

Description of Proposal

The proposal allows the deduction for amortizable bond premium of an individual as an “above-the-line” deduction which reduces adjusted gross income.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

17. Repeal of exclusion, etc., for employee achievement awards (sec. 1417 of the discussion draft and secs. 74(c) and 274(j) of the Code)

Present Law

An employer’s deduction for the cost of an employee achievement award is limited to a certain amount.¹⁵⁸ Employee achievement awards that are deductible by an employer (or would be deductible but for the fact that the employer is a tax-exempt organization) are excluded from an employee’s gross income and wages for employment tax purposes.¹⁵⁹ An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.

Description of Proposal

The proposal repeals the deduction limitation and the exclusion for employee achievement awards.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

18. Clarification of special rule for certain governmental plans (sec. 1418 of the discussion draft and sec. 105(j) of the Code)

Present Law

Reimbursements under an employer-provided accident or health plan for medical care expenses for employees, their spouses, their dependents, and adult children under age 27 are excludible from gross income.¹⁶⁰ However, in order for these reimbursements to be excluded from income, the plan may reimburse expenses of only the employee and the employee’s spouse, dependents, and children under age 27. In the case of a deceased employee, the plan generally

¹⁵⁸ Sec. 274(j).

¹⁵⁹ Secs. 74(c), 3121(a)(20), 3231(e)(5), 3306(b)(16), and 3401(a)(19).

¹⁶⁰ Sec. 105(b).

may reimburse medical expenses of only the employee's surviving spouse, dependents and children under age 27. If a plan reimburses expenses of any other beneficiary, all expense reimbursements under the plan are included in income, including reimbursements of expenses of the employee and the employee's spouse, dependents and children under age 27 (or the employee's surviving spouse, dependents and children under age 27).¹⁶¹

Under a limited exception, reimbursements under a plan do not fail to be excluded from income solely because the plan provides for reimbursements of medical expenses of a deceased employee's beneficiary, without regard to whether the beneficiary is the employee's surviving spouse, dependent, or child under age 27. In order for the exception apply, the plan must have provided, on or before January 1, 2008, for reimbursement of the medical expenses of a deceased employee's beneficiary. In addition, the plan must be funded by a medical trust (1) that is established in connection with a public retirement system, and (2) that either has been authorized by a State legislature, or has received a favorable ruling from the IRS that the trust's income is not includible in gross income by reason of the exclusion for income of a State or political subdivision.¹⁶² This exception preserves the exclusion for reimbursements of expenses of the employee and the employee's spouse, dependents, and children under age 27 (or the employee's surviving spouse, dependents, and children under age 27). Reimbursements of expenses of other beneficiaries are included in income.

Description of Proposal

The proposal expands the exception to apply to plans funded by medical trusts in addition to those covered under present law. As expanded, the exception would apply to a plan funded by a medical trust (1) that is either established in connection with a public retirement system or established by or on behalf of a State or political subdivision thereof, and (2) that either has been authorized by a State legislature or has received a favorable ruling from the IRS that the trust's income is not includible in gross income by reason of either the exclusion for income of a State or political subdivision or the exemption from income tax for a voluntary employees' beneficiary association ("VEBA").¹⁶³ The plan would still be required to have provided, on or before January 1, 2008, for reimbursement of the medical expenses of a deceased employee's beneficiary.

The proposal also clarifies that this exception preserves the exclusion for reimbursements of expenses of the employee and the employee's spouse, dependents, and children under age 27 (or the employee's surviving spouse, dependents, and children under age 27) and that, as under present law, reimbursements of expenses of other beneficiaries are included in income.

¹⁶¹ Rev. Rul. 2006-36, 2006-2 C.B. 353. The ruling is effective for plan years beginning after December 31, 2008, in the case of plans including certain reimbursement provisions on or before August 14, 2006.

¹⁶² This exclusion is provided under Code section 115.

¹⁶³ Tax-exempt status for a VEBA is provided under Code section 501(c)(9).

Effective Date

The proposal is effective with respect to payments made after the date of enactment of the proposal.

19. Limitation on exclusion for employer-provided housing (sec. 1419 of the discussion draft and sec. 119 of the Code)

Present Law

The value of lodging furnished to an employee, spouse, or dependents by or on behalf of an employer for the convenience of the employer (referred to as “employer-provided lodging”) is excluded from the employee's gross income, but only if the employee is required to accept the lodging on the business premises of the employer as a condition of employment. The value of employer-provided lodging is also excluded from wages for employment tax purposes.¹⁶⁴

Description of Proposal

The proposal limits the amount that may be excluded as employer-provided lodging. The exclusion with respect to employer-provided lodging for a taxable year may not exceed \$50,000 (\$25,000 in the case of a married individual filing a separate return). In addition, the exclusion does not apply to more than one residence at any given time. In the case of spouses filing a joint return, the one residence limit may be applied separately to each spouse for a period during which the spouses reside in separate residences provided in connection with their respective employments.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

20. Fringe benefits (sec. 1420 of the discussion draft and sec. 132 of the Code)

Present Law

In general

A fringe benefit that is a no-additional-cost service, qualified employee discount, or a qualified transportation fringe is excluded from an employee's gross income and wages for employment tax purposes.¹⁶⁵

¹⁶⁴ Secs. 3121(a)(19), 3231(e)(9), and 3306(b)(14).

¹⁶⁵ Secs. 132(a)(1), (a)(2), (a)(5), (b), (c) and (f), 3121(a)(20), 3231(e)(5), 3306(b)(16) and 3401(a)(19).

No-additional-cost services and qualified employee discounts

A no-additional-cost service is a service provided by an employer to an employee for use by the employee if (1) the service is offered for sale to customers in the ordinary course of the employer's line of business in which the employee performs services, and (2) the employer incurs no substantial additional cost (including foregone revenue) in providing the service to the employee. A qualified employee discount may apply to services provided by an employer to an employee at a discount (that is, at less than the price the employer offers the services to customers) for use by the employee, (1) if the services are offered for sale to customers in the ordinary course of the employer's line of business in which the employee performs services, and (2) to the extent the discount does not exceed 20 percent of the price at which the services are offered by the employer to customers. For purposes of these exclusions, use by a spouse or dependent child of an employee is treated as use by the employee. In addition, use of air transportation by a parent of an employee is treated as use by the employee.

Qualified transportation fringes

Qualified transportation fringes include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. Qualified transportation fringes also include a cash reimbursement (under a bona fide reimbursement arrangement) by an employer to an employee for parking, transit passes, or vanpooling. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe only if a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

In general, the amount that can be excluded as qualified transportation fringe benefits is limited to \$100 per month in combined transit pass and vanpool benefits and \$175 per month in qualified parking benefits, with the limits being adjusted annually for inflation. For months beginning on or after February 17, 2009¹⁶⁶ and before January 1, 2014, the exclusion limit that applies to employer-provided parking applies also to combined employer-provided transit pass and vanpool benefits. For 2013, the monthly exclusion amount is \$245. After 2013, the lower monthly exclusion amount (as adjusted for inflation) applies to combined employer-provided transit pass and vanpool benefits. For 2014, the monthly exclusion amount for qualified parking benefits is \$250, and the monthly exclusion amount for combined employer-provided transit pass and vanpool benefits is \$130.

With respect to any calendar year, a qualified bicycle commuting reimbursement is an employer reimbursement, during the 15-month period beginning with the first day of the calendar year, for reasonable expenses incurred by an employee during the calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee's residence and place of employment. The exclusion for a qualified bicycle commuting reimbursement for a calendar year is limited to \$20 multiplied by the number of months during the year for which the employee regularly uses the bicycle for a

¹⁶⁶ This is the date of enactment of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

substantial portion of the travel between the employee's residence and place of employment and does not receive any other qualified transportation fringe.

Description of Proposal

The proposal repeals the rule under which, for purposes of a no-additional-cost service or a qualified employee discount, use of air transportation by a parent of an employee is treated as use by the employee.

With respect to the qualified transportation fringe exclusion for parking, the proposal applies a permanent monthly limit of \$250, which is not adjusted in the future for inflation. With respect to the qualified transportation fringe exclusion for employer-provided transit passes, vanpool benefits or combined transit pass and vanpool benefits, the proposal applies a permanent combined monthly limit of \$130, which is not adjusted in the future for inflation. The proposal also repeals the qualified transportation fringe exclusion for qualified bicycle commuting reimbursements.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

21. Repeal of exclusion of net unrealized appreciation in employer securities (sec. 1421 of the discussion draft and sec. 402(e)(4) of the Code)

Present Law

If a qualified retirement plan distributes property, the general rule is that the amount of the distribution is the fair market value of the property on the date of the distribution and amount of the distribution is includible in gross income except to the extent that a portion of the distribution is a return of the employee's investment in the contract.

However, if employer securities are distributed by a qualified retirement plan and either the distribution is a lump sum distribution or the employer securities are attributable to after-tax employee contributions, the net unrealized appreciation in the securities is excluded from the recipient's gross income.¹⁶⁷ Net unrealized appreciation is defined as the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to the trust.¹⁶⁸ In other words, it generally is the amount by which the value of the securities increased while held by the trust of the qualified retirement plan. The basis of the employer

¹⁶⁷ Section 402(e)(4). Under section 402(e)(4)(E), for purposes of this exclusion for net unrealized appreciation, employer securities include shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form including securities of a parent or subsidiary of the employer. See section 402(e)(4)(D) for the definition of a lump sum distribution.

¹⁶⁸ Treas. Reg. sec. 1.402(a)-1(b)(2) provides rules for determining the cost or other basis of employer securities to the trust.

securities after distribution does not include the amount of net unrealized appreciation excluded from gross income.¹⁶⁹

The exclusion for net unrealized appreciation is not available upon subsequent distribution after the securities are contributed to another eligible retirement plan in a tax-free rollover.¹⁷⁰ When the securities are received as part of a lump sum distribution, the recipient may elect not to exclude net unrealized appreciation.¹⁷¹

Description of Proposal

The exclusion for net unrealized appreciation with respect to employer securities is repealed.

Effective Date

The proposal applies to distributions of employer securities after December 31, 2014.

22. Consistent basis reporting between estate and person acquiring property from decedent (sec. 1422 of the discussion draft and secs. 6035 and 6724 of the Code)

Present Law

The value of an asset for purposes of the estate tax generally is the fair market value at the time of death or at the alternate valuation date.¹⁷² The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or as of an alternate valuation date, if elected by the executor.¹⁷³ Under regulations, the fair market value of the property at the date of the decedent's death (or alternate valuation date) is deemed to be its value as appraised for estate tax purposes.¹⁷⁴ However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir.¹⁷⁵ Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may rebut the use of the estate's valuation as his or her

¹⁶⁹ Under Treas. Reg. sec. 1.402(a)-1(b)(1), when employer securities with net unrealized appreciation are sold or exchanged, any gain is treated as long-term capital gain up to the amount of the net unrealized appreciation (regardless of how long the securities were held by the taxpayer). Any gain in excess of the amount of net unrealized appreciation is long-term or short-term gain, depending on how long the taxpayer held the securities after distribution.

¹⁷⁰ Sec. 402(e)(4)(A).

¹⁷¹ Sec. 402(e)(4)(B).

¹⁷² Secs. 2031 and 2032.

¹⁷³ Sec. 1014. See section 1022 for special basis rules apply to property acquired from an electing estate of a decedent who died during 2010.

¹⁷⁴ Treas. Reg. sec. 1.1014-3(a).

¹⁷⁵ See Rev. Rul. 54-97, 1954-1 C.B. 113, 1954.

basis by clear and convincing evidence. The heir is free to rebut the presumption in two situations: (1) the heir has not used the estate tax value for tax purposes, the IRS has not relied on the heir's representations, and the statute of limitations on assessments has not barred adjustments; and (2) the heir does not have a special relationship to the estate which imposes a duty of consistency.¹⁷⁶

Description of Proposal

Under the proposal, if the inclusion of property in an estate increased estate tax liability on such estate, and the value of the property has been finally determined for estate tax purposes, the basis in the hands of the recipient can be no greater than the value of the property as finally determined. If the value of the property is not finally determined for estate tax purposes, then the basis in the hands of the recipient can be no greater than the value reported in a required statement.

An executor of a decedent's estate that is required to file an estate tax return under section 6018(a) is required to report to both the recipient and the IRS the value of each interest in property included in the gross estate. A person that is required to file an estate tax return under section 6018(b) (returns by beneficiaries) is required to report to each other person holding a legal or beneficial interest in property to which the return relates and to the IRS the value of each interest in property included in the gross estate. The required reports must be furnished by the time proscribed by the Secretary, but in no case later than the earlier of 30 days after the return is due under section 6018 or 30 days after the return is filed. In any case where reported information is adjusted after a statement has been filed, a supplemental statement must be filed not later than 30 days after such adjustment is made.

The proposal grants the Secretary authority to prescribe regulations necessary to carry out the proposal, including the application of the proposal when no estate tax return is required to be filed and when the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

The proposal applies the penalty for failure to file correct information returns under section 6721, and failure to furnish correct payee statements under section 6722, to failure to file the new information returns required under the proposal. Additionally, the proposal applies the accuracy-related penalty under section 6662 to any inconsistent estate basis. Inconsistent estate basis for purposes of the accuracy-related penalty is the portion of the understatement attributable to a basis determination with respect to property which is not consistent with the value of the property finally determined for estate tax purposes, or if not finally determined, in accordance with the statement provided under the proposal.

Effective Date

The proposal is applicable to transfers for which an estate tax return is filed after the date of enactment.

¹⁷⁶ See Technical Advice Memorandum 199933001, January 7, 1999.

F. Employment Tax Modification

1. Modifications of deduction for Social Security taxes in computing net earnings from self-employment (sec. 1501 of the discussion draft and sec. 1402(a)(12) of the Code)

Present Law

FICA taxes

The Federal Insurance Contributions Act (“FICA”) imposes tax on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.¹⁷⁷ The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance (“OASDI”) tax equal to 6.2 percent of covered wages up to the taxable wage base (\$117,000 for 2014); and (2) the Medicare or hospital insurance (“HI”) tax equal to 1.45 percent of all covered wages.¹⁷⁸ The employee portion of the FICA tax generally must be withheld and remitted to the Federal government by the employer.

The employer portion of the FICA tax is not treated as income or wages to the employee. That is, it is not included in the employee’s income and is not subject to FICA tax.

SECA taxes

As a parallel to FICA taxes, taxes under the Self-Employment Contributions Act (“SECA”) apply to the self-employment income of self-employed individuals.¹⁷⁹ The rate of the OASDI portion of SECA taxes is generally 12.4 percent, which is equal to the combined employee and employer OASDI tax rates, and applies to self-employment income up to the OASDI taxable wage base (reduced by the individual’s OASDI wages, if any). Similarly, the rate of the HI portion of SECA tax is 2.9 percent, the same as the combined employer and employee HI rates, and there is no cap on the amount of self-employment income to which the rate applies.¹⁸⁰

Self-employment income for SECA purposes means net earnings from self-employment with certain modifications. Net earnings from self-employment generally means the income from a self-employed individual’s trade or business less deductions attributable to the trade or

¹⁷⁷ Secs. 3101-3128.

¹⁷⁸ Beginning 2013, 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 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.

¹⁷⁹ Secs. 1401-1403.

¹⁸⁰ Beginning 2013, an additional 0.9 percent HI tax applies to self-employment income in excess of the threshold amount of \$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.

business. In determining net earnings from self-employment, a self-employed individual is permitted a deduction equal to the product of the taxpayer's net earnings from self-employment determined without regard to this deduction ("preliminary" net earnings from self-employment or NESE) 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 preliminary NESE.¹⁸¹ 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.

Description of Proposal

The proposal modifies the deduction from net earnings from self-employment to make SECA taxes economically equivalent to FICA taxes.¹⁸² Under the proposal, the deduction is determined as the sum of two amounts, corresponding to the OASDI and HI portions of SECA taxes.

The OASDI portion of the deduction is 7.1064 percent of preliminary net earnings from self-employment up to 1.0765 multiplied by the OASDI taxable wage base (reduced by the individual's OASDI wages, if any). The HI portion of the deduction is 1.4293 percent of preliminary net earnings from self-employment in excess of the amount taken into account in determining the OASDI portion of the deduction (that is, preliminary net earnings from self-employment up to 1.0765 multiplied by the OASDI taxable wage base (reduced by the individual's OASDI wages, if any)).

The calculation is summarized in the following table. For purposes of the table, the OASDI base amount is 1.0765 times the OASDI taxable wage base reduced by the individual's OASDI wages, if any.

¹⁸¹ A parallel deduction applies in determining self-employment income for purposes of Social Security benefits. The additional HI tax is not taken into account in computing this deduction. Under section 164(f), a self-employed individual may deduct one-half of SECA taxes (other than the additional HI tax) for income tax purposes.

¹⁸² A parallel change is made to the deduction applicable in determining self-employment income for purposes of Social Security benefits.

Table 3.—Calculation of Deduction Allowed in Determining SECA Taxes

If preliminary NESE are...	Amount of deduction in calculating net earnings from self-employment is...
Up to the OASDI base amount	7.1064 percent of preliminary NESE.
In excess of the OASDI base amount	7.1064 percent of preliminary NESE up to the OASDI base amount, plus 1.4293 percent of preliminary NESE in excess of the OASDI base amount.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Determination of net earnings from self-employment (sec. 1502 of the discussion draft and secs. 3101, 3102, 2111, 1401, and 1402 of the Code)

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”).¹⁸³ A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act (“SECA”).¹⁸⁴

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.¹⁸⁵ The amount of wages subject to this component is capped at \$117,000 for 2014. 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.¹⁸⁶ 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.¹⁸⁷

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 \$117,000 for 2014. 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.¹⁸⁸

¹⁸³ See Chapter 21 of the Code.

¹⁸⁴ Sec. 1401.

¹⁸⁵ Secs. 3101 and 3111.

¹⁸⁶ Beginning 2013, 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 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. Sec. 3101(b).

¹⁸⁷ Sec. 3102.

¹⁸⁸ Beginning 2013, an additional 0.9 percent HI tax applies to self-employment income in excess of the threshold amount of \$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. Sec. 1401(b).

For SECA tax purposes, 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 trade or business that are allowed under the self-employment tax rules.¹⁸⁹ 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.

Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains 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.

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.¹⁹⁰

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. Unlike a partner's distributive share of income or loss from the partnership's trade or business, which is generally subject to SECA tax, an S corporation shareholder's pro rata share of S corporation income is not subject to SECA tax. 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 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.¹⁹¹

¹⁸⁹ 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. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

¹⁹⁰ Sec. 1366.

¹⁹¹ See the discussion of case law in, *e.g.*, 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.

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.¹⁹² In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.¹⁹³ The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.¹⁹⁴ The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.¹⁹⁵

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, gain and loss.¹⁹⁶

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

¹⁹² *David E. Watson, P.C., v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), cert. denied, 133 S. Ct. 364 (2012); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3^d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3^d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to FICA tax.

¹⁹³ See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

¹⁹⁴ *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

¹⁹⁵ In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2^d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

¹⁹⁶ Secs. 701, 702.

types of income, such as rent, dividends, interest, and capital gains and losses, as described above¹⁹⁷). This rule applies to individuals who are general partners.

Limited partners

An exclusion from SECA applies in certain circumstances for limited partners of a partnership.¹⁹⁸ 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.¹⁹⁹

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.²⁰⁰

Description of Proposal

In general

The proposal modifies the determination of net earnings from self-employment under the SECA tax by adding the shareholder's pro rata share of income from S corporations, repealing the exception for limited partners, providing a new deduction related to nonlabor income, and providing a new 100-percent deduction for individuals who do not have material participation.

¹⁹⁷ Sec. 1402(a).

¹⁹⁸ Sec. 1402(a)(13).

¹⁹⁹ In *Renkemeyer, Campbell, & Weaver, LLP, v. Commissioner* (136 T. C. 137, 150 (2011)), 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. See also Amy S. Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," *Tax Notes Today*, March 11, 2011. See also *Howell v. Commissioner* (T.C. Memo. 2012-303, Nov. 1, 2012), in which 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. 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.

²⁰⁰ The proposal also makes parallel changes to corresponding provisions of the Social Security Act.

S corporation shareholders

The proposal provides that net earnings from self-employment generally include the income or loss from any trade or business of an S corporation in which the individual is a stockholder. Specifically, the amount included is the individual's pro rata share of nonseparately computed income or loss described in section 1366(a)(2) from any trade or business carried on by an S corporation in which he is a stockholder.

Under the proposal, the same exceptions apply in determining net earnings from self-employment of a stockholder in an S corporation as apply to a partner in a partnership and to an individual carrying on a trade or business. Thus, the same specified types of income or loss are excluded: rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset, or gains or losses from other property that is neither inventory nor held primarily for sale to customers. Consequently, under this rule, an S corporation shareholder is treated in the same manner as a partner in a partnership under the SECA tax.

The proposal does not change the present-law rules applying FICA tax to wages, including wages paid by an S corporation.

Authority is provided to the Treasury Department to provide regulations or other guidance to coordinate for any year to which the proposal applies the application of the cap (which is \$117,000 for 2014) on wages of an individual from an S corporation that are subject to the FICA tax with the application of the cap to amounts subject to the SECA tax with respect to that individual's pro rata share of income of that S corporation.

Limited partners

The proposal repeals the present-law exclusion for a limited partner's distributive share of partnership income or loss in determining net earnings from self-employment (including repeal of the exception for partnership guaranteed payments in the nature of remuneration for services). Thus, under the proposal, limited partners are treated the same as other partners for purposes of determining net earnings from self-employment. Any person who is treated for Federal income tax purposes as a partner in any entity that is treated for Federal income tax purposes as a partnership is treated as a partner in a partnership for purposes of the SECA tax. Thus, for example, a member of an LLC who is treated for Federal income tax purposes as a partner in a partnership is treated as a partner for purposes of the SECA tax. A person treated as a partner under the Federal income tax is so treated for purposes of the SECA tax regardless of whether the person is treated as a partner under applicable State, local, or foreign law.

Nonlabor income deduction

The proposal provides a deduction that reduces net earnings from self-employment by a percentage that is derived from the historical portion of U.S. gross domestic product that represents income other than labor income. The deduction does not depend in any case on the type or nature of any particular item of income or earnings, but rather is calculated under a formula derived by reference to historical nonlabor income.

Under the proposal, an individual's net earnings from self-employment are reduced (but not below zero) by the lesser of (1) 30 percent of the sum of his pass-through net earnings from self-employment and his FICA wages paid by an S corporation in which he is a shareholder, or (2) his pass-through net earnings from self-employment. Thus, in determining the deduction, both the FICA wages paid by an S corporation to an individual shareholder, and the individual shareholder's pro rata share of S corporation income (subject to SECA), are taken into account.

For example, assume an individual performs services for or on behalf of an S corporation that pays him wages, and the individual also wholly owns the S corporation. Further assume that the S corporation's income (before any deduction for wages) is \$100 for the year, and the individual has wages from the S corporation of \$70 and a pro rata share (as shareholder) of \$30. Under the proposal, 30 percent of the sum of the individual's pass-through net earnings from self-employment and his FICA wages is \$30, and the individual's pass-through net earnings from self-employment are the same amount, \$30. The nonlabor income deduction reduces the individual's net earnings from self-employment by \$30 to \$0. The individual's FICA tax on the \$70 of wages is unaffected. Because both FICA wages and pass-through net earnings from self-employment are subject to payroll tax at the same rate and both are taken into account in determining the nonlabor income deduction, application of the judicially-developed reasonable compensation test is not necessary to determine FICA wages. The nonlabor income deduction is applied after application of the present-law exclusions from net earnings from self-employment for rentals from real estate in certain circumstances, dividends and interest, and gains 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.

Pass-through net earnings from self-employment is defined as net earnings from self-employment (computed without regard to the proposal) determined without regard to any trade or business carried on by the individual. Thus, for example, if the individual carries on a widget business as a sole proprietor, and also is a partner in a gadget business carried on by the partnership, pass-through net earnings from self-employment is determined with regard only to the gadget business of the partnership, and does not take into account the widget business the individual conducts as a sole proprietor. The Treasury Department is accorded regulatory authority to reallocate items of income, gain, or loss among businesses in which the taxpayer has an interest in any capacity, to carry out the purposes of the proposal.

100-percent deduction for individuals who do not have material participation

The proposal generally provides a 100-percent deduction from net earnings from self-employment for specified amounts in circumstances in which an individual does not have material participation with respect to an entity.

The rule has the effect that an individual's net earnings from self-employment are separated into items from nonparticipation entities, and items that are not from nonparticipation entities. An individual's net earnings from self-employment generally are reduced (but not below zero) by the sum of (1) the reduction determined above under the nonlabor income deduction, but modified to take account only of items from nonparticipation entities at 100 percent, and (2) the reduction determined above under the nonlabor income deduction, but modified to take account only of items that are not from nonparticipation entities at 30 percent.

For this purpose, a nonparticipation entity with respect to any individual is any entity with respect to which the individual does not have material participation.

An individual does not have material participation with respect to a top-tier entity if the individual demonstrates to the satisfaction of the Treasury Department that he or she does not materially participate in any activity carried on by the top-tier entity, and does not materially participate in any activity carried on by any other entity in which the top-tier entity directly or indirectly holds an interest. For this purpose, material participation has the same meaning as under the passive loss rules (sec. 469(h)). The participation of an individual in any activity is treated as including that of the individual's spouse and the lineal descendants of the individual and the individual's spouse.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Repeal of exemption from FICA taxes for certain foreign workers (sec. 1503 of the discussion draft and secs. 3121(b)(1) and (b)(19) and section 3231(e)(1) of the Code)

Present Law

FICA imposes tax on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.²⁰¹ The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base (\$117,000 for 2014); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.²⁰²

Wages as defined for FICA purposes means all remuneration for employment, with certain specified exceptions. Employment as defined for FICA purposes generally means any service, of whatever nature, performed by an employee for an employer within the United States, with certain specified exceptions.²⁰³

Exceptions from employment apply to service performed by certain categories of employees who are lawfully admitted to the United States on a temporary basis in order to work, specifically, agricultural workers holding H-2A visas and individuals (for example, certain

²⁰¹ Secs. 3101-3128.

²⁰² Beginning 2013, 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 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.

²⁰³ The Social Security Act provides exceptions to "wages" and "employment" that parallel the FICA tax exceptions. Therefore, compensation or services that are not subject to FICA tax are also not taken into account in determining Social Security benefits.

students, researchers, and cultural exchange participants) holding F-1, J-1, M-1, Q-1 or Q-2 visas.²⁰⁴ Exceptions from employment apply also to certain other types of service, and, in some cases, an employee's service may be eligible for both a FICA exception applicable to certain visa holders and also for another exception.

Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act (“RRTA”), to taxes equivalent to the OASDI and HI taxes under FICA with respect to compensation as defined for RRRTA purposes (“RRRTA compensation”).²⁰⁵ An exception applies for individuals holding F-1, J-1, M-1, Q-1 or Q-2 visas.²⁰⁶

Description of Proposal

Under the proposal, the FICA and RRRTA exceptions for services performed as employees by agricultural workers holding H-2A visas or individuals holding F-1, J-1, M-1, Q-1 or Q-2 visas are repealed.²⁰⁷ Thus, FICA taxes apply to wages paid to these employees (and RRRTA taxes apply to compensation) unless another exception applies.

Effective Date

The proposal is effective with respect to remuneration received for services performed after December 31, 2014.

4. Repeal of exemption from FICA taxes for certain students (sec. 1504 of the discussion draft and sec. 3121(b)(2) and (b)(10) of the Code)

Present Law

FICA imposes tax on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.²⁰⁸ The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance (“OASDI”) tax equal to 6.2 percent of covered wages up to

²⁰⁴ Sec. 3121(b)(1) and (b)(16).

²⁰⁵ Secs. 3201-3233. Under section 3211(a), combined employer and employee rates apply to the RRRTA compensation of an employee representative, defined under section 3231(c) generally as an officer or official representative of a railway labor organization. Under sections 3201(b), 3211(b) and 3221(b), RRRTA compensation is also subject to an additional tax, referred to as the “Tier 2” tax.

²⁰⁶ Sec. 3231(e)(1).

²⁰⁷ The parallel exemptions under the Social Security Act for services performed as employees by agricultural workers holding H-2A visas and individuals holding F-1, J-1, M-1, Q-1 or Q-2 visas are also repealed under the proposal.

²⁰⁸ Secs. 3101-3128.

the taxable wage base (\$117,000 for 2014); and (2) the Medicare or hospital insurance (“HI”) tax equal to 1.45 percent of all covered wages.²⁰⁹

Wages as defined for FICA purposes means all remuneration for employment, with certain specified exceptions. Employment as defined for FICA purposes generally means any service, of whatever nature, performed by an employee for an employer within the United States, with certain specified exceptions.²¹⁰

An exception from employment for FICA purposes applies in the case of certain services performed by a student in the employ of a school, college, or university.²¹¹ Specifically, FICA does not apply to services performed by a student who is enrolled and regularly attending classes at the school, college, or university. A FICA exception applies also to domestic service performed in a local college club, or local chapter of a college fraternity or sorority, by a student who is enrolled and regularly attending classes at a school, college, or university.²¹² Exceptions from employment apply also to certain other types of service, and, in some cases, an employee's service may be eligible for both a FICA exception applicable to students and also for another exception.

Some FICA exceptions are subject to dollar limits. For example, cash remuneration of less than a specified amount (\$1,900 for 2014) paid to an employee in a year for domestic service in a private home is exempt from FICA.²¹³ The FICA rules provide that, in cases in which a FICA exception is subject to a dollar limit, the employer may withhold the employee share of

²⁰⁹ Beginning 2013, 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 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.

²¹⁰ The Social Security Act provides exceptions to “wages” and “employment” that parallel the FICA tax exceptions. Therefore, compensation or services that are not subject to FICA tax are also not taken into account in determining Social Security benefits.

²¹¹ Sec. 3121(b)(10) and Treas. Reg. sec. 31.3121(b)(10)-2. The exception also applies to services performed as a student in the employ of an organization that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the school, college, or university, if the organization is operated, supervised or controlled by or in connection with such school, college, or university. The Social Security Act provides an exception for students that parallels the FICA exception and that applies for purposes of Social Security and Medicare coverage. Under section 218 of the Social Security Act, a State may enter into a voluntary agreement with the Social Security Administration to provide Social Security and Medicare coverage for groups of State or local government employees who are not mandatorily covered (commonly referred to as a “section 218” agreement). Generally, all the employees in a group must be covered by the agreement, but section 218 permits the exclusion of students who meet the requirements under the parallel student exception under the Social Security Act.

²¹² Sec. 3121(b)(2) and Treas. Reg. sec. 31.3121(b)(2)-1.

²¹³ Sec. 3121(a)(7)(B).

FICA from payments made to the employee even though, at the time of payment, the total amount paid to the employee is less than the limit and, thus, may be exempt from FICA.²¹⁴

Under the Social Security Act, an individual's wages are credited to the individual's earnings record for purposes of determining an individual's eligibility for Social Security benefits and Medicare coverage and for purposes of determining the amount of an individual's Social Security benefits. Eligibility for Social Security benefits and Medicare coverage is based in part on credits (referred to as "quarters of coverage") received for wages. Up to four quarters of coverage can be earned for a year, depending on total wages for the year and the amount needed to earn each quarter of coverage. For 2014, credit for a quarter of coverage is provided for each \$1,200 of wages, with a maximum of four quarters of coverage for \$4,800 in wages.

Description of Proposal

The proposal amends the FICA exceptions for students by adding a dollar limit. Specifically, a FICA exception applies to a student for a year only if the student's earnings are less than the amount needed to receive a quarter of FICA coverage for the year (\$1,200 for 2014).²¹⁵ Thus, if a student's earnings exceed the limit, the student's earnings are subject to FICA unless another FICA exception applies. If the limit is exceeded, all of the individual's earnings are subject to FICA, including earnings up to the limit, thus enabling the individual to receive at least one quarter of coverage for the year.

Under the proposal, the rules and procedures relating to the withholding of the employee share of FICA that apply under present law in the case of FICA exceptions that are subject to dollar limits apply also for purposes of the student exception. For example, the employer may withhold the employee share of FICA from payments made to the employee even though, at the time of payment, the total amount paid to the employee is less than the limit.

Effective Date

The proposal is effective for remuneration received for services performed after December 31, 2014.

²¹⁴ See sec. 3102(a) and Treas. Reg. sec. 31.3102-1(b). Treas. Reg. sec. 31.6402(a)-2 provides procedures for situations in which FICA taxes are erroneously withheld from an employee's pay. Under these procedures, the employer generally repays the employee for the erroneously withheld amount. In addition, if the employer has paid the erroneously withheld amount to the IRS, the employer may take credit for the amount in determining future taxes that must be paid to the IRS.

²¹⁵ The proposal also adds a dollar limit to the parallel exceptions for students under the Social Security Act, which therefore applies also for purposes of excluding students under a section 218 agreement.

5. Override of Treasury guidance providing that certain employer-provided supplemental unemployment benefits are not subject to employment taxes (sec. 1505 of the discussion draft and sec. 3402(o)(1)(A) and (o)(2)(A) of the Code)

Present Law

Employment taxes

Employment taxes generally consist of taxes on employee wages under the Federal Insurance Contributions Act (“FICA”), the Railroad Retirement Tax Act (“RRTA”) and the Federal Unemployment Tax Act (“FUTA”), and required Income Tax Withholding (“ITW”) from employee wages.²¹⁶ For these purposes, wages is defined broadly to include all remuneration, subject to exceptions specifically provided in the relevant statutory provisions.²¹⁷ Remuneration does not fail to be subject to employment taxes merely because it is paid after termination of employment.²¹⁸

Dismissal pay and supplemental unemployment benefits

Income tax withholding is required with respect to dismissal payments, described as any payments made by an employer to an employee on account of dismissal (that is, involuntary separation from the service of the employer), regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments.²¹⁹ Dismissal payments are also subject to FICA and FUTA.²²⁰ Similarly, lump sum separation and severance allowances paid to laid-off employees in the railway industry are subject to RRTA.²²¹

The IRS has established a limited administrative exception to the application of FICA, RRTA, FUTA and income tax withholding in the case of supplemental unemployment benefit (“SUB”) pay meeting certain requirements.²²² In order to qualify for the exception, SUB pay

²¹⁶ Secs. 3101-3128, 3201-3233, 3301-3311, and 3401-3404, respectively. RRTA taxes apply to employee compensation, as defined under RRTA. However, for purposes of this discussion, the term “wages” includes RRTA compensation.

²¹⁷ See, e.g., the next to the last sentence of section 3121(a) providing that an exclusion from wages for income tax withholding purposes is not to be construed to require a similar exclusion from wages for FICA purposes. Similar rules are provided for RRTA purposes (in the last sentence of section 3231(e)(1)) and FUTA purposes (in the last sentence of section 3306(b)).

²¹⁸ Treas. Reg. secs. 31.3121(a)-1(i), 31.3306(b)-1(i) and 31.3401(a)-1(a)(5).

²¹⁹ Treas. Reg. sec. 31.3401(a)-1(b)(4).

²²⁰ Rev. Rul. 71-408, 1971-2 C.B. 340, which also notes that FICA and FUTA previously contained statutory exceptions for dismissal payments that the employer was not legally required to make, but which were repealed in 1950.

²²¹ Rev. Rul. 65-251, 1965-2 C.B. 395.

²²² Rev. Rul. 90-72, 1990-2 C.B. 211. However, these payments are subject to income tax withholding under section 3402(o)(1), as discussed herein.

benefits must be linked to eligibility for State unemployment compensation and must not be paid in a lump sum.²²³

Income tax withholding is required with respect to the payment of supplemental unemployment compensation benefits.²²⁴ For this purpose, the term supplemental unemployment compensation benefits means amounts paid to an employee, pursuant to a plan to which the employer is a party, because of the employee's involuntary separation from employment (whether or not the separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income.

Description of Proposal

Under the proposal, various revenue rulings providing employment tax exclusions for supplemental unemployment benefits are null and void, as are any other Treasury or IRS ruling, regulation or other guidance to the extent that such ruling, regulation or guidance provides that any payment made by reason of involuntary termination of employment, including any supplemental unemployment benefit, is not wages for purposes of any Code provision. Thus, the employment tax exclusions established administratively under IRS guidance for SUB pay no longer apply and all supplemental unemployment benefits are subject to FICA, RRTA and FUTA taxes and income tax withholding. The proposal does not override the application of any statutory employment tax exceptions.

The proposal also repeals the present-law provision requiring income tax withholding on supplemental unemployment compensation benefits. These amounts are subject to income tax withholding as wages.

Effective Date

The proposal making various revenue rulings and other rulings, regulations or other guidance null and void is effective for amounts paid after December 31, 2014. Repeal of the present-law provision requiring income tax withholding on supplemental unemployment compensation benefits is effective for amounts paid after December 31, 2013. Repeal of this

²²³ The SUB pay exception was originally established under Rev. Rul. 56-249, 1956-1 C.B. 488, which dealt with benefits payable only to individuals who are unemployed and generally meet the eligibility requirements for State unemployment benefits. Rev. Rul. 56-249 was later amplified and modified by Rev. Rul. 58-128, 1958-1 C.B. 89, Rev. Rul. 60-330, 1960-2 C.C. 46, and Rev. Rul. 77-347, 1977-2 C.B. 362, which applied the exception to benefits that were not tied to the receipt of State unemployment benefits. Rev. Rul. 90-72 states that Rev. Rul. 77-347 is inconsistent with the underlying premises of the exception and revokes Rev. Rul. 77-347.

²²⁴ Sec. 3402(o)(1)(A) and (2)(A). Under section 501(c)(17), a trust forming part of a plan providing supplemental unemployment compensation benefits may be exempt from tax. In *Quality Stores v. United States*, 693 F. 3d 605 (6th Cir. 2012), the court considered the existence of the income tax withholding requirement under section 3402(o) to provide a basis for holding that payments that do not qualify for the IRS administrative exception for SUB pay are nonetheless exempt from FICA. That decision conflicts with an earlier decision in *CSX Corporation v. United States*, 518 F. 2d 1328 (Fed. Cir. 2008) and review of the *Quality Stores* decision is before the Supreme Court. *United States v. Quality Stores*, 82 U.S.L.W. 3177 (Oct. 1, 2013).

income tax withholding requirement is not to be construed to create any inference with respect to the exclusion from wages or compensation of any amounts paid before January 1, 2014.

6. Certified professional employer organizations (sec. 1506 of the discussion draft and new secs. 3511 and 7706 of the Code)

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act (“FICA”), the taxes under the Railroad Retirement Tax Act (“RRTA”), the tax under the Federal Unemployment Tax Act (“FUTA”), and income taxes required to be withheld by employers from wages paid to employees (“income tax withholding”).²²⁵

FICA tax consists of two parts: (1) old age, survivor, and disability insurance (“OASDI”), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance (“HI”). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base for the calendar year (\$117,000 for 2014). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.²²⁶

RRTA taxes consist of tier 1 taxes and tier 2 taxes. Tier 1 taxes parallel the OASDI and HI taxes applicable to employers and employees. Tier 2 taxes consist of employer and employee taxes on railroad compensation up to the tier 2 wage base for the calendar year.

Under FUTA, employers must pay a tax of 6 percent of wages up to the FUTA wage base of \$7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions means payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees’ remuneration.

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

²²⁵ Secs. 3101-3128 (FICA), 3201-3241 (RRTA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

²²⁶ Beginning 2013, 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 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.

Wages paid to employees, and FICA, RRTA, and income taxes withheld from the wages, are required to be reported on employment tax returns and on Forms W-2.²²⁷

Employment taxes generally apply to all remuneration paid by an employer to an employee. However, various exclusions apply to certain types of remuneration or certain types of services, which may depend on the type of employer for whom an employee performs services.²²⁸ For example, remuneration (subject to a dollar limit) paid to an employee by a tax-exempt organization is excluded from wages for FICA purposes, and services performed in the employ of certain tax-exempt organizations are excluded from employment for FUTA purposes.²²⁹ In addition, various definitions and special rules apply to certain types of employers.²³⁰

As discussed above, certain employment taxes apply only on amounts up to a specified wage base. If an employee works for multiple employers during a year, separate wage bases generally apply to each employer. However, a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base applies in certain cases in which an employer (a “successor” employer) takes over the business of another employer (the “predecessor” employer) and employs the employees of the predecessor employer.

Responsibility for employment tax compliance

Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.²³¹ Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether an employer-employee relationship exists often arises in determining whether a worker is an employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.

In some cases, a person other than the common-law employer (a “third party”) may be liable for employment taxes. For example, if wages are paid to an employee by a third party and

²²⁷ Secs. 6011 and 6051.

²²⁸ See, e.g., secs. 3121(a) and (b), 3231(e), 3306(b) and (c), and 3401(a).

²²⁹ Secs. 3121(a)(16) and 3306(c)(8).

²³⁰ See, e.g., secs. 3121, 3122, 3125, 3126, 3127, 3231, 3306, 3308, 3309, 3401(a), 3404, 3506, and 3510.

²³¹ Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

the third party, rather than the employer, has control of the payment of the wages, the third party is the statutory employer responsible for complying with applicable employment tax requirements.²³² In addition, an employer may designate a reporting agent to be responsible for FICA tax and income tax withholding compliance,²³³ including filing employment tax returns and issuing Forms W-2 to employees.²³⁴ In that case, the reporting agent and the employer are jointly and severally liable for compliance.²³⁵

Professional employer organizations

A professional employer organization (sometimes called an employee leasing company) is a term used for a firm that provides employees to perform services in the businesses of the professional employer organization's customers, generally small and medium-sized businesses. In many cases, before the professional employer organization arrangement is entered into, the employees already work in the customer's business as employees of the customer. The terms of a typical professional employer organization arrangement provide that the professional employer organization is the employer of the employees and is responsible for paying the employees and for the related employment tax compliance. The customer typically pays the professional employer organization a fee based on payroll costs plus an additional amount.²³⁶

In some cases, the employees provided to work in the customer's business are legally the employees of the customer, and the customer is legally responsible for employment tax compliance. Nonetheless, customers generally rely on the professional employer organization for employment tax compliance (without designating the professional employer organization as a reporting agent) and treat the employees as employees of the professional employer organization.

²³² Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. United States*, 38 Fed. Cl. 450 (1997), and *Winstead v. United States*, 109 F. 2d 989 (4th Cir. 1997).

²³³ The designated reporting agent rules generally do not apply for purposes of FUTA compliance.

²³⁴ Sec. 3504. Form 2678 is used to designate a reporting agent.

²³⁵ For administrative convenience, an employer may also use a payroll service to handle payroll and employment tax filings on its behalf, but the employer, not the payroll service, continues to be responsible for employment tax compliance.

²³⁶ A professional employer organization may also provide employees with employee benefit coverage, such as under a pension plan or a health plan, even if the customer does not maintain such a plan. In such a case, the fee paid by the customer also covers employee benefit costs.

Reporting by large food and beverage establishments

Certain reporting requirements relating to tips apply to large food or beverage establishments.²³⁷ In the case of such an establishment, an employer is generally required to report the following information to the IRS each calendar year: (1) the gross receipts of the establishment from the provision of food and beverages (other than certain receipts); (2) the aggregate amount of charge receipts (other than certain receipts); (3) the aggregate amount of charged tips on the charge receipts; (4) the sum of the aggregate amount of tips reported to the employer by employees and certain amounts required to be reported by the employer on employees' Form W-2s; and (5) with respect to each employee, the amount of tips allocated to the employee based on the receipts of the establishment. The employer must also provide employees with written statements showing certain information each calendar year, including the amount of tips allocated to the employee for the year.

User fees

User fees apply to requests to the IRS for ruling letters, opinion letters, determination letters, and similar requests.²³⁸ The user fees that apply are determined by the IRS and are generally required to be determined after taking into account the average time and difficulty involved in a request.

Description of Proposal

Treatment of certified professional employer organization as employer for employment tax purposes

Under the proposal, if certain requirements are met, for purposes of employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of any work site employee performing services for any customer of the certified professional employer organization, but only with respect to remuneration remitted to the work site employee by the certified professional employer organization. In addition, no other person is treated as the employer for employment tax purposes with respect to remuneration remitted by the certified professional employer organization to a work site employee.

Under the proposal, exceptions, exclusions, definitions, and other rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the proposal continue to apply. Thus, for example, if services performed in the employ of a customer that is a tax-exempt organization would be excluded from employment for FUTA purposes, the fact that a certified professional employer organization is treated as the employer for employment tax purposes does not affect the application of the exclusion.

²³⁷ Sec. 6053(c).

²³⁸ Sec. 7528.

The proposal provides rules under which, on entering into a service contract with a customer with respect to a work site employee, a certified professional employer organization is treated as a successor employer and the customer is treated as the predecessor employer. Similarly, on termination of a service contract with respect to a worksite employee, the customer is treated as a successor employer and the certified professional employer organization is treated as a predecessor employer. Thus, wages paid by the customer and the certified professional employer organization to a work site employee during a calendar year are subject to a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base.

The proposal does not apply in the case of a customer who is related to the certified professional employer organization.²³⁹ In addition, an individual with net earnings from self-employment derived from a customer's trade or business (i.e., a self-employed individual), including a customer who is a sole proprietor or a partner of a customer that is a partnership, is not a work site employee for employment tax purposes with respect to remuneration paid by a certified professional employer organization.

As discussed more fully below, a work site employee is an individual who performs services (1) for a customer pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements and (2) at a work site that meets certain requirements. Thus, if the contract or work site fails to meet these requirements, the individual is not a work site employee. The proposal applies also in the case of an individual (other than a self-employed individual) who is not a work site employee, but who performs services under a contract that meets the specified requirements. In this case, solely for purposes of a certified professional employer organization's liability for employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of such an individual, but only with respect to remuneration remitted to the individual by the certified professional employer organization. With respect to such an individual, exceptions, exclusions, definitions, and other rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the proposal continue to apply.

A certified professional employer organization is eligible for the FUTA credit with respect to contributions made to a State unemployment fund with respect to a work site employee by the certified professional employer organization or a customer. An additional FUTA credit may be claimed by a certified professional employer organization if, under State law, a certified professional employer organization is permitted to collect and remit contributions with respect to a work site employee to the State unemployment fund.

Except to the extent necessary for purposes of the proposal treating a certified professional employer organization as the employer for employment tax purposes, nothing in the

²³⁹ Whether a customer and a certified professional employer organization are related is determined under the rules of section 267(b) (relating to transactions between related taxpayers) or 707(b) (relating to transactions between a partner and partnership). However, rules based on more than 50 percent ownership are applied by substituting 10 percent for 50 percent.

proposal is to be construed to affect the determination of who is an employee or employer for purposes of the Code.

Certified professional employer organization

A certified professional employer organization is a person who has been certified by the Secretary of the Treasury (“Secretary”), for purposes of being treated as the employer for employment tax purposes under the proposal, as meeting certain requirements. These requirements are met if the person:

- demonstrates that the person (and any owner, officer, and such other persons as may be specified in regulations) meets requirements established by the Secretary with respect to tax status, background, experience, business location, and annual financial audits;
- agrees to satisfy the bond and independent financial review requirements (described below) on an ongoing basis;
- agrees to satisfy any reporting obligations imposed by the Secretary;
- computes its taxable income using an accrual method of accounting unless the Secretary approves another method;
- agrees to verify on such periodic basis as prescribed by the Secretary that it continues to meet the requirements for certification; and
- agrees to notify the Secretary in writing within such time as prescribed by the Secretary of any change that materially affects the continuing accuracy of any agreement or information that was previously made or provided.

Under the bond requirement, a certified professional employer organization must post a bond for the payment of employment taxes in a minimum amount and in a form acceptable to the Secretary. The minimum amount is determined for the period April 1 of any calendar year through March 31 of the following calendar year and is the greater of (1) five percent of the employment taxes for which the certified professional employer organization is liable under the proposal during the preceding calendar year (but not to exceed \$1,000,000), or (2) \$50,000. However, during the first three full calendar years that a professional employer organization is in existence, the amount described in (1) of the preceding sentence does not apply. For this purpose, under rules provided by the Secretary, an organization is treated as in existence as of the date that it begins providing services to any client that are comparable to the services being provided with respect to work site employees, regardless of whether such date occurred before or after the organization is certified by the IRS. If a certified professional employer organization has employment tax liability of more than \$5,000,000 for a calendar year, the exception no longer applies as of April 1 of the following year.

Under the independent financial review requirements, a certified professional employer organization must: (1) have, as of the most recent audit date (that is, six months after the completion of the certified professional employer organization’s fiscal year), caused to be prepared and provided to the Secretary an opinion of an independent certified public accountant as to whether the certified professional employer organization’s financial statements are

presented fairly in accordance with generally accepted accounting principles; and (2) provide to the Secretary, not later than the last day of the second month beginning after the end of each calendar quarter, from an independent certified public accountant an assertion regarding Federal employment tax payments and an examination level attestation on the assertion. The assertion must state that the certified professional employer organization has withheld and made deposits of all required FICA, RRTA, and withheld income taxes for the calendar quarter, and the attestation must state that the assertion is fairly stated in all material respects. If a certified professional employer organization fails to file the required assertion and attestation with respect to any calendar quarter, the independent financial review requirements are treated as not satisfied for the period beginning on the due date for the attestation.

For purposes of the bond and independent financial review requirements, all professional employer organizations that are members of a controlled group of corporations or under common control are treated as a single organization.²⁴⁰ The Secretary may suspend or revoke the certification of a person's certified professional employer organization status if the Secretary determines that the person does not satisfy the representations or other requirements for certification or fails to satisfy the applicable accounting, reporting, payment, or deposit requirements.

Work site employee

A work site employee is an individual who: (1) performs services for a customer of a certified professional employer organization pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements (described below); and (2) performs services at a work site meeting certain requirements (described below).²⁴¹

The contract between the customer and the certified professional employer organization must be in writing and, with respect to an individual performing services for the customer, must provide that the certified professional employer organization will:

- assume responsibility for payment of wages to the individual, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for reporting, withholding, and paying any employment taxes with respect to the individual's wages, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for any employee benefits that the contract may require the certified professional employer organization to provide, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for recruiting, hiring and firing workers in addition to the customer's responsibility for recruiting, hiring and firing workers;

²⁴⁰ Whether entities are members of a controlled group of corporations or under common control is determined under the rules of section 414(b) and (c).

²⁴¹ As discussed above, a self-employed individual is not a work site employee.

- maintain employee records relating to the individual; and
- agree to be treated as a certified professional employer organization for employment tax purposes with respect to such individual.

For purposes of whether an individual is a work site employee, the work site where the individual performs services meets the applicable requirements if at least 85 percent of the individuals performing services for the customer at the work site are subject to one or more contracts with the certified professional employer organization that meet the above requirements.²⁴²

Regulations

The Secretary is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal. The Secretary is also directed to develop reporting and recordkeeping rules, regulations, and procedures to ensure compliance with the proposal with respect to entities applying for and receiving certification as certified professional employer organizations. These are to be designed in a manner to streamline, to the extent possible, the application of the requirements of the proposal, the exchange of information between a certified professional employer organization and its customers, and the reporting and recordkeeping obligations of a certified professional employer organization.

Other rules

Reporting by large food and beverage establishments

Under the proposal, if a certified professional employer organization is treated for employment tax purposes as the employer of a work site employee, the customer for whom the work site employee performs services is the employer for purposes of the reporting required with respect to a large food or beverage establishment. The certified professional employer organization is required to furnish the customer with any information necessary to complete the required reporting.

User fees

Under the proposal, the user fee charged under the program for certifying a professional employer organization is an annual fee and may not exceed \$1,000.

No inference as to effect of proposal

Nothing contained in the proposal or the amendments made by the proposal is to be construed to create any inference with respect to the determination of who is an employee or employer (1) for Federal tax purposes (other than the purposes set forth in the proposal), or (2) for purposes of any other provision of law.

²⁴² For this purpose, excluded employees under section 414(q)(5), such as employees who are under age 21 or have not completed six months of service, are not taken into account.

Effective Date

The proposal is effective with respect to wages paid for services performed on or after January 1 of the first calendar year beginning more than 12 months after the date of enactment of the proposal. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the proposal becomes effective.

G. Pensions and Retirement

1. Changes to rules for individual retirement arrangements (secs. 1601 through 1604 of the discussion draft and secs. 219, 408, and 408A of the Code)

Present Law

Individual retirement arrangements

There are two basic types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs,²⁴³ to which both deductible and nondeductible contributions may be made,²⁴⁴ and Roth IRAs, to which only nondeductible contributions may be made.²⁴⁵ 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, 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 qualified distributions are not includible in gross income.

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 a certain dollar amount (\$5,500 for 2014) or 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. The dollar limit is increased to reflect increases in the cost-of living using calendar year 2007 as the base year. The index used is the consumer price index for all-urban consumers published by the Department of Labor (CPI-U). However, if the amount of any increase is not a multiple of \$500, the increase is rounded down to the nearest multiple of \$500.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to \$1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) 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 (“AGI”)

²⁴³ Sec. 408.

²⁴⁴ Sec. 219.

²⁴⁵ Sec. 408A.

for the taxable year over certain indexed levels.²⁴⁶ 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. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

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.²⁴⁷ All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

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 2014 for Roth IRA contributions are: (1) for single taxpayers, \$114,000 to \$129,000; (2) for married taxpayers filing joint returns, \$181,000 to \$191,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

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 \$10,000.²⁴⁸

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 treated as a single contract for purposes of determining the amount that is a return of contributions.

Separation of traditional and Roth IRA accounts

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. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

²⁴⁶ Sec. 219(g). Certain modifications apply in determining AGI for this purpose and determining eligibility to make Roth IRA contributions.

²⁴⁷ Basis results from after-tax contributions to traditional IRAs or rollovers to traditional IRAs of after-tax amounts from another eligible retirement plan.

²⁴⁸ Sec. 408A(d)(2).

Taxpayers generally may convert an amount in a traditional IRA into a Roth IRA.²⁴⁹ 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.²⁵⁰ The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

Rollovers to IRAs of distributions from tax-favored employer-sponsored plans (qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan must be contributed to a traditional IRA and distributions from a designated Roth account are only permitted to be contributed to a Roth IRA. A distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from an eligible employer plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.²⁵¹

Recharacterization

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (by a trustee-to-trustee transfer to the other type of IRA) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.²⁵² In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a prorata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may divide up the amount being converted and establish multiple Roth IRAs (for example, Roth IRAs with different investment strategies) and select which Roth IRA

²⁴⁹ Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

²⁵⁰ The early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

²⁵¹ Sec. 408A(d)(3) and Notice 2008-30, 2008-12 I.R.B. 638. As in the case of a Roth IRA conversion of an amount from a traditional IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.

²⁵² Sec. 408A(d)(6).

to recharacterize as a traditional IRA by transferring the entire amount in the account to a traditional IRA (for example, the entire amount in the account of any IRA for which the value of the assets in the account declines during the year).²⁵³ The individual may then later convert that traditional IRA to Roth IRA, including the lower value in income. Treasury regulations prevent the conversion from taking place immediately after the recharacterization. The regulations require a minimum period to elapse before a reconversion after a recharacterization (meaning a conversion of an amount previously contributed to a Roth IRA in a Roth conversion and then recharacterized as a contribution to a traditional IRA).²⁵⁴ Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.

Simple IRA plans and simplified employee pensions

Simple IRA plans and simplified employee pensions are special types of employer-sponsored retirement plans under which the employer makes contributions to IRAs established for each of its employees in accordance with the Code requirements for each type of plan. Only contributions to traditional IRAs are allowed for these plans.

Rollover contributions from employer sponsored retirement plans

Distributions from tax-favored employer-sponsored plans are permitted to be rolled over tax-free to a traditional IRA or another tax-favored employer-sponsored plan.

Description of Proposal

Under the proposal, the rules for IRAs are changed as described below.

Elimination of income limits on contributions to Roth IRAs

The AGI limits on making contributions to a Roth IRA are eliminated. Thus contributions are permitted to be made to a Roth IRA by a taxpayer for a year regardless of the taxpayer's AGI.

No deductible or nondeductible contributions to traditional IRAs

No deductible or nondeductible contributions are allowed to be made to traditional IRAs. Only rollover contributions of distributions from other traditional IRAs or tax-favored retirement plans and contributions under a SIMPLE IRA plan or a simplified employee pension plan are allowed to be made to a traditional IRA. Nondeductible contributions continue to be allowed to be made to Roth IRAs.

²⁵³ A-2 of Treas. Reg. sec. 1.408A-5.

²⁵⁴ Treas. Reg. sec. 1.408A-5.

Suspension of inflation adjustment of dollar limit on contributions to Roth IRAs

The proposal suspends cost-of-living adjustments to the dollar limit on contributions to Roth IRAs through 2023. Thus, the 2014 annual limit on contributions to a Roth IRA remains at \$5,500 through 2023. Cost-of-living adjustments resume beginning with 2024 using calendar year 2022 as the base year, rounding down to the nearest multiple of \$500 (as under present law). As under present law, Roth IRA catch-up contributions are not indexed, and thus remain at \$1,000 per year even after 2023.

Repeal of special rule permitting recharacterization of IRA contributions

Under the proposal, the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA is repealed. Thus, for example, under the proposal, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion) because the investment experience of the Roth IRA after the conversion resulted in net losses, rather than net gains, and the individual wanted to be able to convert that amount at the lower value, including in income only that lower value.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Repeal of exception to 10-percent penalty for first-time home purchases and elimination of first-time home purchase as a qualified distribution from a Roth IRA (sec. 1605 of the discussion draft and secs. 72(t) and 408A of the Code)

Present Law

Early distribution tax

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans, and IRAs before an employee (or an IRA owner) attains age 59½ unless an exception applies.²⁵⁵ The tax is equal to 10 percent of the amount of the distribution that is includible in gross income.²⁵⁶ One of the exceptions is for qualified first-time homebuyer distributions which are distributions from IRAs used for first-time homebuyer expenses that meet certain requirements and are limited to \$10,000.²⁵⁷

²⁵⁵ Sec. 72(t).

²⁵⁶ The 10-percent tax is in addition to the taxes that would otherwise be due on distribution.

²⁵⁷ Qualified first-time homebuyer distribution is defined in section 72(t)(8).

Qualified distributions from Roth IRAs

There are two basic types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs,²⁵⁸ to which both deductible and nondeductible contributions may be made,²⁵⁹ and Roth IRAs, to which only nondeductible contributions may be made.²⁶⁰ 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, 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, qualified distributions from the Roth IRA are not includible in gross income.

A qualified distribution from a Roth IRA 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 of the IRA owner, or is a qualified first-time home buyer distribution.²⁶¹ 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.

Description of Proposal

The proposal repeals the exception from the 10 percent early distribution tax for qualified first-time homebuyer distributions from IRAs. The proposal also eliminates qualified first-time home buyer distributions as a basis for a distribution from a Roth IRA being a qualified distribution (and thus not includible in gross income).

Effective Date

The proposal is effective for distributions after December 31, 2014.

3. Termination of new simplified employee pensions (sec. 1611 of the discussion draft and sec. 408(k) of the Code)

Present Law

A simplified employee pension (“SEP”) is a type of tax-favored employer-sponsored retirement plan under which an employer may make contributions to a SEP IRA for each eligible employee up to the lesser of 25 percent of the employee’s compensation or the dollar limit

²⁵⁸ Sec. 408.

²⁵⁹ Sec. 219.

²⁶⁰ Sec. 408A.

²⁶¹ Sec. 408A(d)(2).

applicable to contributions to a qualified defined contribution plan (\$52,000 for 2014).²⁶² All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least \$550 (for 2014) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP (“SARSEP”) under which employees could make elective deferrals. However, contributions may continue to be made to SARSEPs that were established before 1997. Elective deferrals under a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan (\$17,500 for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SARSEP up to a limit of \$5,500 (for 2014).

Description of Proposal

Under the proposal, a new SEP plan is not permitted to be established by an employer after December 31, 2014. However, contributions are permitted to continue to any SEP plan of an employer maintaining a SEP plan for its employees as of December 31, 2014 if such SEP plan and the terms thereof satisfy the requirements for SEPs on and after December 31, 2014. Thus, under the SEP plan of the employer, contributions may be made to a SEP IRA of an employee of the employer even if the employee did not participate in the plan on that date and the SEP IRA for the employee is established after that date.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

4. Termination for new SIMPLE 401(k) plans (sec. 1612 of the discussion draft and sec. 401(k)(11) of the Code)

Present law

A small employer that employs no more than 100 employees who earned \$5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called a simple retirement plan. There are two types of simple retirement plans, one that is a form of section 401(k) plan (“SIMPLE 401(k) plan”) and the other is a plan under which contributions are made to an individual retirement arrangement for each employee (a “SIMPLE IRA plan”). A simple retirement plan allows employees to make elective deferrals, subject to a limit of \$12,000 (for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a simple retirement plan up to a limit of \$2,500 (for 2014). A SIMPLE 401(k) plan is deemed to satisfy the nondiscrimination tests that otherwise apply to elective deferrals and matching contributions.

²⁶² Sec. 408(k).

Employer contributions to a simple retirement plan generally must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective deferrals on a dollar-for-dollar basis up to three percent of the employee's compensation. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible employee whether or not the employee makes elective deferrals. No contributions other than employee elective deferrals, required employer matching contributions, or employer nonelective contributions can be made to a simple retirement plan.

Description of Proposal

Under the proposal, a new SIMPLE 401(k) plan is not permitted to be established by an employer for plan years beginning after December 31, 2014. However, contributions are permitted to continue to any SIMPLE 401(k) plan in existence for the last plan year beginning before January 1, 2015, but only if the arrangement meets the requirements for being a SIMPLE 401(k) plan for such plan year and each plan year thereafter.

Effective Date

The proposal applies to plan years beginning after December 31, 2014.

5. Rules related to designated Roth contributions (sec. 1613 of the discussion draft and secs. 401(a)(30), 402(g), 402A, and 408(p) of the Code)

Present Law

Section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans

In general

A qualified retirement plan that is a profit-sharing plan or stock bonus plan (and certain money purchase pension plans) may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement.²⁶³ A plan with this feature is generally referred to as a section 401(k) plan. A section 403(b) plan may allow a similar salary reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.²⁶⁴

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements generally are referred to as 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

²⁶³ Sec. 401(k).

²⁶⁴ Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

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.²⁶⁵ However, the plan is not permitted to only allow employees to make designated Roth contributions; pretax elective deferrals must also be permitted.²⁶⁶ 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 dollar 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, which is \$17,500 for 2014.²⁶⁷ An employee age 50 or over is allowed to contribute an additional catch up amount of \$5,500 for 2014.²⁶⁸

If an individual's total elective deferrals for a taxable year under section 401(k) plans and section 403(b) plans exceed the \$17,500 limit plus, if applicable, the catch-up contributions limit, and the plan distributes the excess (plus allocable income) by April 15 following the taxable year, the excess amount is includable in the individual's gross income.²⁶⁹ If the excess is not distributed by April 15, the excess is includable in gross income but the individual receives no basis in the account for the amount included in gross income. Thus, that amount will be taxed again when distributed. In the case of an excess in the form of designated Roth contributions that is not distributed by April 15, any distribution attributable to the excess cannot be a qualified distribution, and the individual is not entitled to basis to reflect that the excess amount is an after-tax contribution.

A governmental section 457(b) plan may also provide for elective deferrals. Contributions to a governmental section 457(b) plan are subject to a dollar limit of \$17,500 (for 2014) plus an additional \$5,500 catch-up contribution limit (for 2014) for participants at least

²⁶⁵ Sec. 402A.

²⁶⁶ Treas. Reg. secs. 1.401(k)-1(f) and 1.403(b)-3(c).

²⁶⁷ An employee with compensation less than \$17,500 may make elective contributions only up to the amount of his or her compensation. Pursuant to section 415(c) and 403(b)(1), total contributions (including elective contributions) for an employee to a section 401(k) plan or 403(b) plan for a plan year for an employee generally cannot exceed \$52,000 for 2014 (or the employee's compensation, if less). In some cases additional elective contributions or other contributions may be made under a section 403(b) plan.

²⁶⁸ The total of an employee's elective contributions, including catch-up contributions, cannot exceed the employee's compensation.

²⁶⁹ Generally, the employee informs a plan that an excess has occurred and requests that the plan distribute the excess amount.

age 50 (or the participant's compensation, if less).²⁷⁰ This limit is separate from the limit on elective deferrals to section 401(k) and section 403(b) plans.²⁷¹ 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.

Designated Roth accounts

All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). A 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 5-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 income under the contract and excluded from gross income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis.

SIMPLE IRA plan

An eligible employer can establish a simplified tax-favored retirement plan, which is called a SIMPLE IRA plan. An eligible employer is an employer which had no more than 100 employees who received at least \$5,000 of compensation from the employer for the preceding year. Compensation for this purpose is wages reported on the employees Form W-2 plus elective pretax deferrals. An employer that maintains a SIMPLE IRA plan for one or more years and then exceeds this limit may remain an eligible employer for 2 years following the year in which the employer last satisfied the limit.

A SIMPLE IRA under a SIMPLE IRA plan is not permitted to be a Roth IRA. Under a SIMPLE IRA plan, contributions are made only to a traditional IRA (not a Roth IRA) for each employee (a "SIMPLE IRA"). A SIMPLE IRA plan allows employees to make pretax elective deferrals to a SIMPLE IRA, subject to a limit of \$12,000 (for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE IRA plan up to a limit of \$2,500 (for 2014). The employer is required to make certain specified matching or nonelective contributions to the SIMPLE IRA for each eligible employee. In the case of a SIMPLE IRA plan, the group of eligible employees generally must include any

²⁷⁰ 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.

²⁷¹ 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 \$17,500 (plus \$5,500 catch-up contributions if at least age 50) to the section 403(b) plan and up to \$17,000 (plus \$5,500 catch-up contributions if at least age 50) to the section 457(b) plan. This separate application of the elective contribution limit for governmental section 457(b) plans is eliminated by section 1618 of the discussion draft.

employee who has received at least \$5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive \$5,000 in the current year.²⁷²

Description of Proposal

Limit on pretax elective deferrals

Except as described below for plans of eligible employers, under the proposal, the combined limit on pretax elective deferrals under section 401(k) plans and 403(b) plans, and pretax deferrals under a governmental section 457(b) plan is reduced to one half the dollar limits on total elective deferrals and catch-up contributions (the aggregate amount of pretax elective deferrals and designated Roth contributions). Thus, the general limit on pretax elective deferrals is \$8,750 (one half of \$17,500), and the catch-up contribution limit is \$2,750 (one half of \$5,500). As a result, for an employee over age 50, the general elective contribution limit applicable to the aggregate amount of pretax elective deferrals and designated Roth contributions is \$23,000, but the pretax elective deferrals cannot exceed one half that amount or \$11,500.

Qualified Roth contribution program

The limit on designated Roth contributions is the full \$17,500 limit, plus (if applicable) the full \$5,500 catch up contribution limit, reduced by the amount of any pretax elective deferrals. Under the proposal, section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans are permitted to offer only a qualified Roth contribution program with respect to elective deferrals (both with respect to the \$17,500 limit and the \$5,500 catch-up contribution limit), and are not required to also offer employees the opportunity to make pretax elective deferrals.²⁷³

Plan maintained by an eligible employer

The rule reducing the limit on pretax elective deferrals to one half the elective deferral limit and, if applicable, the catch-up contribution limit does not apply to a section 401(k) plan, section 403(b) plan, or governmental section 457(b) plan, maintained by an eligible employer. Under the proposal, the only change to the present-law rules applicable to one of these types of plans maintained by an eligible employer is that the plan is permitted to only allow designated Roth contributions (under a qualified Roth contribution program) and is not required to also allow pretax elective deferrals. Otherwise the rules remain unchanged. Thus, the employer may maintain a plan that only allows pretax elective deferrals and the limit remains the maximum limit of \$17,500 (plus \$5,500 catch up, if applicable). Reporting will be required on the

²⁷² An employer is permitted to exclude collectively bargained employees described in section 410(b)(3)(A).

²⁷³ As under present law, employer matching and nonelective contributions under section 401(k) plan and 403(b) plans are made on a pretax basis.

employee's Form W-2 to identify that the elective deferrals are under a plan of an eligible employer.

The definition of an eligible employer for this purpose is the definition of an eligible employer under the SIMPLE IRA plan rules, generally an employer that had no more than 100 employees who received at least \$5,000 of compensation from the employer for the preceding year with a 2-year grace period for an employer with employees that exceed this limit.

SIMPLE IRA plans

The proposal permits a SIMPLE IRA to be a Roth IRA. The proposal also allows a SIMPLE IRA plan to permit employees to choose to make after-tax elective deferrals to Roth IRAs in lieu of elective deferrals to traditional IRAs, subject to the combined limit of \$12,000 (plus \$2,500 for catch-up contributions, if applicable). However, a SIMPLE IRA plan is also permitted to continue to only allow pretax elective deferrals to traditional IRAs.

The proposal also provides a new option for a SIMPLE IRA plan under which the plan may provide for elective deferrals up to the full limit of \$17,500 plus catch-up contributions of \$5,500 (applicable to elective deferrals under section 401(k) and 403(b) plans, and governmental section 457(b) plans), but only if the plan allows after-tax elective deferrals to be made to a SIMPLE IRA that is a Roth IRA and does not allow pretax elective deferrals to be made to traditional IRAs in excess of one half the applicable limit, \$8,750 plus catch-up contributions, if applicable of \$2,750.²⁷⁴

Effective Date

The proposal is effective for plan years and taxable years beginning after December 31, 2014. With respect to SIMPLE IRA plans, the proposal is effective for calendar year beginning after December 31, 2014.

6. Modification of required distribution rules for pension plans (sec. 1614 of the discussion draft and sec. 401(a)(9) of the Code)

Present Law

Minimum distribution rules²⁷⁵ apply to employer sponsored tax-favored retirement plans²⁷⁶ and individual retirement arrangements ("IRAs"). In general, under these rules,

²⁷⁴ As under present law, employer matching and nonelective contributions under a SIMPLE IRA plan (including a SIMPLE IRA plan that takes advantage of this proposal) are made to a traditional IRA.

²⁷⁵ Sec. 401(a)(9), 403(b)(1), 408(a)(6), 408(b)(3), 457(d)(2).

²⁷⁶ Tax-favored employer-sponsored retirement plans include qualified retirement plans and annuities under sections 401(a) and 403(a), tax-deferred annuity plans under section 403(b), and governmental eligible deferred compensation plans under section 457(b). Tax-favored retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for

distribution of minimum benefits must begin no later than a required beginning date and a minimum amount must be distributed each year.²⁷⁷ Minimum distribution rules also apply to benefits payable with respect to an employee (or IRA owner) who has died. The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA.²⁷⁸ In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the stream of annuity payments must satisfy. Failure to comply with the minimum distribution requirement results in an excise tax imposed on the individual who was required to take the distributions equal to 50 percent of the required minimum amount not distributed for the year. The excise tax may be waived in certain cases. For qualified retirement plans, satisfying the minimum distribution requirement under the plan terms and operation is also a qualification requirement for the trust of the plan to remain tax-exempt.

Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the employee (or IRA owner) attains age 70½. For employer-sponsored tax-favored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under an employer-sponsored tax-favored retirement plan in the year the employee attains age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

Lifetime rules

While an employee (or IRA owner) is alive, distributions of the individual's interest are required to be made (in accordance with regulations) over the life or life expectancy of the employee (or IRA owner), or over the joint lives or joint life expectancy of the employee (or IRA owner) and a designated beneficiary.²⁷⁹ For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee (or IRA owner) is alive, is the factor for the employee (or IRA owner's) age from the uniform lifetime table included in the

each participant, to which are allocated contributions, earnings and losses. Minimum distribution requirements also apply to eligible deferred compensation plans under section 457(b) of tax-exempt employers.

²⁷⁷ Under section 408A(c)(5), these lifetime requirements do not apply to a Roth IRA.

²⁷⁸ Reflecting the direction from Congress in section 823 of the Pension Protection Act (Pub. L. No. 109-280), pursuant to Treas. Reg. sec. 1.401(a)(9)-1, A-2(d), a governmental plan within the meaning of section 414(d) or an governmental eligible deferred compensation plan is treated as having complied with the statutory minimum distribution rules if the plan complies with a reasonable and good faith interpretation of those rules.

²⁷⁹ Sec. 401(a)(9)(A).

Treasury regulations.²⁸⁰ This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. The distribution period for annuity payments under a defined benefit plan or annuity contract (to the extent not limited to the life of the employee (or IRA owner) or the joint lives of the employee (or IRA owner) and a designated beneficiary) is generally subject to the same limitations as apply to individual accounts.

Distributions after death

Payments over a distribution period

The after-death minimum distributions rules vary depending on (1) whether an employee (or IRA owner) dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit.²⁸¹ Under the regulations, a designated beneficiary is an individual designated as a beneficiary under the plan or IRA.²⁸² Similar to the lifetime rules, for defined contribution plans and IRAs (“individual accounts”), the required minimum distribution for each year after the death of the employee (or IRA owner) is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

If an employee (or IRA owner) dies on or after the required beginning date, the basic statutory rule is that the remaining interest must be distributed at least as rapidly as under the method of distribution being used before death.²⁸³ Under the regulations, for individual accounts, this rule is also interpreted as requiring the minimum required distribution to be calculated using a distribution period. If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee’s (or IRA owner’s) life, as of the year of death.²⁸⁴ If there is a designated beneficiary, the distribution period (if longer) is the

²⁸⁰ Treas. Reg. sec. 1.401(a)(9)-5. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple’s joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

²⁸¹ In the case of amounts for which the employee or IRA owner’s surviving spouse is the beneficiary, the surviving spouse generally is permitted to do a tax-free rollover of such amounts into an IRA (or account of a tax-favored employer-sponsored plan of the spouse’s employer) established in the surviving spouse’s name as IRA owner or employee. The rules applicable to the rollover account, including the minimum distribution rules, are the same rules that apply to an IRA owner or employee. In the case of an IRA for which the spouse is sole beneficiary, this is can be accomplished by simply renaming the IRA as an IRA held by the spouse as IRA owner rather as a beneficiary.

²⁸² Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan (or IRA). There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, the fact that an interest under a plan or IRA passes to a certain individual under a will or otherwise under State law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan or IRA.

²⁸³ Sec. 401(a)(9)(B)(i).

²⁸⁴ Treas. Reg. sec. 1.401(a)(9)-5, A-5(a)(2).

beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of death.²⁸⁵

If an employee (or IRA owner) dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, the statutory rule is that distributions are generally required to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and are permitted to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary. If the beneficiary of the employee (or IRA owner) is the individual's surviving spouse, distributions are not required to commence until the year in which the employee (or IRA owner) would have attained age 70½. If the surviving spouse dies before the employee (or IRA owner) would have attained age 70½, the after-death rules apply after the death of the spouse as though the spouse were the employee (or IRA owner). Under the regulations, for individual accounts, the required minimum distribution for each year is determined using a distribution period and the period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual died on or after the required beginning date.²⁸⁶

In cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee (or IRA owner) or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period.²⁸⁷

The distribution period for annuity payments under a defined benefit plan or annuity contract (to the extent not limited to the life of a designated beneficiary) is generally subject to the same limitations as apply to individual accounts.

Five-year rule

If an employee (or IRA owner) dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee (or IRA owner) must generally be distributed by the end of the fifth year following the individual's death.²⁸⁸

²⁸⁵ Treas. Reg. sec. 1.401(a)(9)-5, A-5(a)(1).

²⁸⁶ Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

²⁸⁷ If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

²⁸⁸ There are provisions in the regulations allowing a designated beneficiary to take advantage of the 5-year rule. See Treas. Reg. secs. 1.401(a)(9)-4, A-4, and 1.4974-2, A-7(b).

Defined benefit plans and annuity distribution

The regulations provide rules for the amount of annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five-percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.²⁸⁹ If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee (or IRA owner), the survivor annuitant is limited to a percentage of the life annuity benefit for the employee (or IRA owner). The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

Description of Proposal

Required beginning date

Under the proposal, if an employee becomes a five-percent owner after age 70½ but before retiring and thus before the employee's required beginning date with respect to tax-favored retirement plans of the employee's employer, the required beginning date for that employee becomes April 1 of the year following the year that the employee becomes a five-percent owner.

Other than the modification to the required beginning date for five-percent owners, the proposal makes no changes to the required minimum distribution rules during the lifetime of the employee (or IRA owner). Thus, for example, the proposal is not expected to result in a change to the regulations under section 401(a)(9) for required minimum distributions during the lifetime of the employee (or IRA owner) under which the required minimum distribution for each year is generally determined by dividing the account balance as of the end of the prior year by a distribution period which is the number corresponding to the employee's (or IRA owner's) age for the year from the uniform lifetime table included in the Treasury regulations.

After death rules

General rule

Under the proposal, the five-year rule is the general rule for all distributions after death (regardless of whether the employee (or IRA owner) dies before, on, or after the required beginning date) unless the designated beneficiary is an eligible beneficiary as defined in the proposal.

²⁸⁹ Treas. Reg. sec. 1.401(a)(9)-6, A-14.

Eligible beneficiaries

For eligible beneficiaries, the exception to the five-year rule (for death before the required beginning date under present law) applies whether or not the employee (or IRA owner) dies before, on, or after the required beginning date. The exception generally allows distributions over life or life expectancy of an eligible beneficiary beginning in the year following the year of death. Eligible beneficiaries includes any beneficiary who, as of the date of death, is the surviving spouse of the employee (or IRA owner), is disabled, is a chronically ill individual, is an individual who is not more than 10 years younger than the employee (or IRA owner), or is a child of the employee (or IRA owner) who has not reached the age 22. In the case of a child who has not reached the age 22, under the exception to the five-year rule, calculation of the minimum required distribution under this exception is only allowed through the year that the child reaches age 22.

However, unlike present law, under the proposal, the five-year rule also applies after the death of an eligible beneficiary or after a child reaches age 22. Thus for example, if a disabled child of an employee (or IRA owner) is an eligible beneficiary of a parent who dies when the child is age 20 and the child dies at age 30, even though 52.1 years remain in the life expectancy of the child calculated for the child's age (21) in the year after the employee's (or IRA owner's) death, the disabled child's remaining beneficiary interest must be distributed by the end of the fifth year following the death of the disabled child. If a child is an eligible beneficiary based on having not reached the age 22 before the employee's (or IRA owner's) death, the five-year rule applies beginning with the earlier of date of the child's death or the date that the child reaches age 22. The child's entire interest must be distributed by the end of the fifth year following that date.

As under present law, if the surviving spouse is the beneficiary, there is a special rule that allows the commencement of distribution to be delayed until end of the year that the employee (or IRA owner) would have been age 70½. If the spouse dies before distributions were required to begin to the spouse, the surviving spouse is treated as the employee (or IRA owner) in determining the required distributions to beneficiaries of the surviving spouse.

Definition of disabled and chronically ill individual

Under the proposal, the definition of disabled in section 72(m)(7) is incorporated by reference. Under this definition, disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to end in death or to be for long-continued and indefinite duration. Under section 72(m)(7), an individual is not considered to be disabled unless proof of the disability is furnished in such form and manner as the Secretary may require. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).²⁹⁰

²⁹⁰ Treas. Reg. sec. 1.72-17(f). Under the regulations, in determining whether an individual is disabled, primary consideration is given to the nature and severity of the individual's impairment. However, consideration is

Under the proposal, the definition of a chronically ill individual for qualified long-term care insurance under section 7702B(c)(2) is incorporated by reference with a modification. Under this definition, a chronically ill individual is any individual who (1) is unable to perform (without substantial assistance from another individual) at least two activities of daily living for an indefinite period (expected to be lengthy in nature)²⁹¹ due to a loss of functional capacity, (2) has a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above requiring assistance with daily living based on loss of functional capacity, or (3) requires substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. The activities of daily living for which assistance is needed for purposes of determining loss of functional capacity are eating, toileting, transferring, bathing, dressing, and continence.

Defined benefit plans and annuities

The new general rule under the proposal applies to all after-death distributions under all retirement plans subject to the required minimum distribution requirements, including annuity distributions under defined benefit plans and distributions under qualified annuity contracts distributed by individual accounts. Thus, for example, under the proposal, after the death of an employee (or IRA owner), distribution in the form of the survivor life annuity (including a distribution that began before death as a joint and survivor annuity) is only permitted to an eligible beneficiary.

Plan amendments to comply with the proposal

It is intended that Treasury and IRS will provide sponsors of qualified retirement plans relief from the anti-cut back rules for amendments to eliminate forms of benefit with respect to benefits already accrued to the extent necessary to comply with the proposal²⁹² and provide all plans a remedial amendment period that provides sufficient time to amend the terms of their plans to reflect this change to the minimum distributions requirements.²⁹³

also given to other factors such as the individual's education, training, and work experience. Whether or not an impairment in a particular case constitutes a disability is determined with reference to all the facts in the case.

²⁹¹ Section 7702B(c) only requires this period to be at least 90 days.

²⁹² Section 411(d)(6) prohibits a plan from being amended to eliminate optional forms of benefit with respect to benefits already accrued except to the extent prescribed in regulations. Treas. Reg. sec. 1.411(d)-4(b)(2)(i) authorizes the IRS to provide relief under which a plan is allowed to be amended to eliminate optional forms of benefit to the extent necessary to comply with a statutory change. In contrast to defined benefit plans, a defined contribution plan with respect to benefits already accrued may be amended to eliminate optional forms of benefit, provided that, after elimination of the form, a single sum payment is available at the same time or times as the form of benefit being eliminated and the single sum is based on the same or greater portion of the account balance as the form of distribution being eliminated.

²⁹³ Pursuant to section 401(b), the regulation thereunder, and Rev Proc. 2007-44, 2007-2I C.B. 54, in the case of a statutory change in the qualification requirements applicable to a retirement plan, an employer generally has at least until 8½ months after the employer's taxable year (within which the plan year ends for which the

Effective Date

Required beginning date change for five-percent owners

For the proposal changing the definition of required beginning date for employees who become five-percent owners after age 70½, the proposal applies to any employee who becomes five-percent owner with respect to plan years ending in calendar years beginning before, on, or after the date of the enactment. If an employee became a five percent owner with respect to a plan year ending in a calendar year before January 1, 2014, and the employee has not retired before the calendar year 2014, the employee's required beginning date is April 1, 2015. However if under present law, an employee's required beginning date occurred before April 1, 2015 because the employee retired during a year before 2014, the proposal does not cause the employee to have an earlier required beginning date.

Required distributions after death

For determining minimum required distributions after the death of an employee (or IRA owner), the proposal is generally effective for distributions with respect to employees (or IRA owners) who die after December 31, 2014.

In the case of an employee (or IRA owner) who dies before January 1, 2015, if the designated beneficiary of the employee (or IRA owner) dies after December 31, 2014, the proposal applies to any beneficiary of the designated beneficiary as though the designated beneficiary were an eligible beneficiary. Thus, the entire interest must be distributed by the end of the fifth year after the death of the designated beneficiary.

In the case of an employee (or IRA owner) who dies after December 31, 2014, the proposal does not apply to a qualified annuity that is a binding annuity contract in effect on the date of the enactment and at all times thereafter. To be a qualified annuity, the annuity must be a commercial annuity (as defined in section 3405(e)(6)) or an annuity payable by a defined benefit plan, and (2) an annuity under which the annuity payments are substantially equal periodic payments (not less frequently than annually) over the lives of such employee (or IRA owner) and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee (or IRA owner) or the life expectancy of such employee (or IRA owner) and a designated beneficiary) in accordance with the required minimum distribution regulations for annuity payments (as in effect before enactment of this proposal). In addition to these requirements, to be a qualified annuity, annuity payments to the employee (or IRA owner) must begin before January 1, 2015 and the employee (or IRA owner) must have made an irrevocable election before that date as to the method and amount of the annuity payments to the employee

statutory change is first effective) to amend the plan to comply with the statutory change. The amendment must be retroactively effective to the date that the change first applies to the plan and the plan must comply operationally with the change in law and with the plan as amended during the period that the amendment is retroactively effective. The regulations also provide that the IRS can extend this time period for amending the plan, and Rev. Proc 2007-44 provides an additional period to make corrections to the initial plan amendment. Also see Rev. Roc. 2009-36, 2009-2, C.B. 309 for a special rule for governmental plans.

or any designated beneficiaries. Alternatively, if an annuity is not a qualified annuity solely based on annuity payments not having begun irrevocably before January 1, 2015, an annuity can be a qualified annuity if the employee (or IRA owner) has made an irrevocable election before the date of enactment as to the method and amount of the annuity payments to the employee (or IRA owner) or any designated beneficiaries.

7. Reduction in age for allowable in-service distributions (sec. 1615 of the discussion draft and secs. 401(a)(36) and sec. 457(d)(1) of the Code)

Present Law

Overview

There are three basic types of funded tax-favored employer-sponsored defined contribution plans: qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. These tax-favored employer-sponsored retirement plans are accorded special tax treatment under present law. Most contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed, even if the arrangement is funded and benefits are vested. Additionally, many distributions can be rolled over to another plan for further deferral of income inclusion. Defined contribution plans may provide for nonelective contributions and matching contributions by employers and elective deferrals or after-tax contributions by employees. Elective deferrals are contributions made pursuant to an election by an employee between cash compensation and a contribution to the plan.

Elective deferrals under a qualified retirement plan may only be made under a section 401(k) plan. A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement.²⁹⁴ Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements. One requirement is that no distributions prior to severance from employment generally are permitted for amounts attributable to elective deferrals unless the employee has attained age 59½.

Section 403(b) plans are another form of tax-favored employer-sponsored plan that provide tax benefits similar to qualified retirement plans. Section 403(b) plans may be maintained only by (1) charitable organizations tax-exempt under section 501(c)(3), and (2) educational institutions of State or local governments (*i.e.*, public schools, including colleges and universities). Elective deferrals are also permitted under section 403(b) plans and are subject to the same requirement that generally no distributions are permitted prior to severance from employment unless the employee has attained age 59½.

²⁹⁴ Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

Governmental section 457(b) plans

In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).²⁹⁵ However distributions from a governmental section 457(b) plan prior to severance from employment are generally not permitted until the employee attains age 70½.²⁹⁶

Pension plans

For purposes of the qualification requirements applicable to pension plans, stock bonus plans, and profit-sharing plans under the Code, a pension plan is a plan established and maintained primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually life, after retirement.²⁹⁷ A pension plan (i.e., a defined benefit plan or money purchase pension plan) generally may not provide for distributions before the attainment of the normal retirement age under the plan to participants who have not separated from employment. However, a pension plan is not treated as failing to be a qualified retirement plan solely because the plan provides that a distribution may be made to an employee who has attained age 62 (even if earlier than the normal retirement age under the plan) and who is not separated from employment at the time of the distribution.²⁹⁸

Description of Proposal

The proposal changes the age at which distributions are permitted prior to termination of employment to age 59½ for both pension plans and governmental section 457(b) plans, thus making the rules for these plans consistent with the rules for section 401(k) plans and section 403(b) plans. Under the proposal, a pension plan does not fail to be a qualified retirement plan solely because the plan provides that a distribution may be made to an employee who has attained age 59½ and who is not separated from employment at the time of the distribution.

Effective Date

The proposal is effective for distributions made after December 31, 2014.

²⁹⁵ In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.

²⁹⁶ Sec. 457(d)(1)(A)(i).

²⁹⁷ Treas. Reg. sec. 1.401-1(b)(1)(i).

²⁹⁸ Sec. 401(a)(36).

8. Modification of rules governing hardship distributions (sec. 1616 of the discussion draft and sec. 401(k)(2) of the Code)

Present Law

Elective deferrals under a qualified cash or deferred arrangement (a “section 401(k) plan”) may not be distributable prior to the occurrence of one or more specified events.²⁹⁹ One event upon which distribution is permitted is the financial hardship of the employee.³⁰⁰ The amount allowed to be distributed on account of hardship is limited to the dollar amount of elective deferrals reduced for the amount of elective deferrals previously distributed on account of hardship. Applicable Treasury regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.³⁰¹

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective deferrals and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution. The same rules apply to hardship distributions of elective deferrals from section 403(b) plans.

Description of Proposal

The Secretary of the Treasury is directed to revise the applicable regulations within one year of the date of enactment to eliminate the requirement that an employee be prohibited from making elective deferrals and employee contributions for six months after the receipt of a hardship distribution in order for the distribution to be deemed necessary to satisfy an immediate and heavy financial need. It is intended that an employee not be prevented for any period after the receipt of a hardship distribution from continuing to make elective deferrals and employee contributions.

Effective Date

The proposal applies to plan years beginning after December 31, 2014.

²⁹⁹ A section 401(k) plan legally is not a separate type of plan, but is a qualified retirement plan that contains a qualified cash or deferred arrangement.

³⁰⁰ Sec. 401(k)(2)(B)(i)(IV).

³⁰¹ Treas. Reg. sec. 1.401(k)-1(d)(3).

9. Extended rollover period for the rollover of plan loan offset amounts in certain cases (sec. 1617 of the discussion draft and sec. 402(c) of the Code)

Present Law

Taxation of retirement plan distributions

General rule

A distribution from a tax-favored retirement plan is generally includible in gross income, except to the extent that the distribution is a recovery of basis under the plan, or the amount of distribution is contributed to another eligible retirement plan in a tax-free rollover. In the case of a distribution from a retirement plan to a participant under age 59½, the distribution (other than a distribution from certain governmental plans) is also subject to a 10-percent early distribution tax, unless an exception applies.

Rollovers

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. 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”). Amounts that are rolled over are usually not included in gross income.³⁰² Generally, any distribution 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.³⁰³

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.³⁰⁴ If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.³⁰⁵ Participants who do not

³⁰² Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA. Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account (discussed below) must be included in gross income.

³⁰³ Sec. 402(c)(4). 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). In addition, pursuant to section 402(c)(11), any distribution to a beneficiary other than the participant’s surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.

³⁰⁴ Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cashout of more than \$1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

³⁰⁵ Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent withheld will remain taxable unless the participant substitutes funds within the 60-day period.

Plan loan as a deemed distribution

Tax-favored employer-sponsored retirement plans may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan.³⁰⁶ These requirements include the following: the amount of the loan must not exceed the lesser of 50 percent of the participant's account balance or \$50,000; the terms of the loan must provide for a repayment period of not more than five years and provide for level amortization of loan payments (with payments not less frequently than quarterly); and the terms of the loan must be legally enforceable. Loans specifically for home purchases may be repaid over a longer period. Thus if a plan participant ceases to make payments on a loan before it is repaid, a deemed distribution of the outstanding loan balance generally occurs.

A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. However, a deemed distribution is not eligible for rollover to another eligible retirement plan.

Loan offset amount

A plan may also provide that, in certain circumstances (for example, upon a participant's termination of employment with the employer), a participant's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in participant's account balance is offset by the amount attributable to the loan (the amount of the unpaid loan balance). In the case of a loan offset, an actual distribution equal to the unpaid loan balance (as opposed to a deemed distribution under section 72(p)) occurs, and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

Description of the Proposal

Under the proposal, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs (meaning the taxable year in which such amount is treated as distributed from a qualified employer plan). Under the proposal, a qualified plan loan offset amount is a plan loan offset amount which is treated as distributed from a qualified retirement plan, a section 403(b) plan or a governmental section 457(b) plan to a participant or beneficiary solely by reason of either the termination of the plan, or the failure to

³⁰⁶ Sec. 72(p).

meet the repayment terms of the loan from such plan because of the separation from service of the participant (whether due to layoff, cessation of business, termination of employment, or otherwise). As under present law, a loan offset amount under the proposal is the amount by which a participant's accrued benefit under the plan is reduced to repay a loan from the plan.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

10. Coordination of contribution limitations for 403(b) plans and governmental 457(b) plans (sec. 1618 of the discussion draft and secs. 402(g), 403(b), 415 and 457(b) of the Code)

Present Law

There are three types of account-based tax-favored employer-sponsored retirement plans: a qualified defined contribution plan, a tax-sheltered annuity plan (referred to as a section 403(b) plan), and an eligible deferred compensation plan of a State or local government (referred to as a governmental section 457(b) plan). A qualified defined contribution plan may include a qualified cash or deferred arrangement (referred to as a section 401(k) plan), under which an employee elects to have contributions made to the plan (referred to as elective deferrals) rather than receiving the same amount as cash compensation. Elective deferrals are generally made on a pretax basis unless designated by the participant as Roth contributions, which are made on an after-tax basis. A defined contribution plan may also provide for after-tax employee contributions and for employer nonelective contributions and matching contributions. A section 403(b) plan may also provide for these different types of contributions. Although a governmental section 457(b) plan may provide for employer contributions, these plans generally provide only for elective deferrals.

In the case of a section 401(k) plan or a section 403(b) plan, specific annual limits apply to elective deferrals by a participant and additional annual limits apply to aggregate contributions for the participant. For 2014, elective deferrals are generally limited to the lesser of (1) \$17,500 plus an additional \$5,500 catch-up contribution limit for participants at least age 50 and (2) the participant's compensation. If an employee participates in both a section 401(k) plan and a section 403(b) plan of the same employer,³⁰⁷ a single limit applies to elective deferrals under both plans. However, under a special rule, in the case of employees who have completed 15 years of service, additional elective deferrals are permitted under a section 403(b) plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. In this case, the annual limit is increased by the least of (1) \$3,000, (2) \$15,000 reduced by the employee's additional elective deferrals for previous years, and (3) \$5,000 multiplied by the employee's years of service and reduced by the employee's elective deferrals for previous years.

³⁰⁷ For this purpose members of a controlled group or affiliated service group are treated as a single employer.

For 2014, the limit on aggregate contributions to a qualified defined contribution plan (including a section 401(k) plan) or a section 403(b) plan is the lesser of (1) \$52,000 and (2) the participant's compensation.³⁰⁸ Because employees generally do not receive compensation for years after they have terminated employment, contributions generally cannot be made for former employees. However, under a special rule, employer contributions to a section 403(b) plan can be made for up to five years after termination of employment. In addition, under special rules, certain contribution amounts are permitted for church employees and foreign missionaries.

The limit described above on aggregate contributions to a qualified defined contribution plan applies to contributions for a participant to any defined contribution plans maintained by the same employer, defined generally to include any members of a controlled group (using an ownership standard of more than 50 percent, rather than at least 80 percent) or affiliated service group. Similarly, the limit on aggregate contributions to a section 403(b) plan applies to contributions for a participant to any section 403(b) plan maintained by the same employer, including any members of a controlled group or affiliated service group. However, contributions to a qualified defined contribution plan and to a section 403(b) plan maintained by the same employer are subject to separate limits unless the participant in the section 403(b) plan is in control of the employer maintaining the qualified defined contribution plan. This could occur, for example, if the participant in the section 403(b) plan owns a separate business that maintains a qualified defined contribution plan. In that case, a single limit applies to the contributions for the participant to the section 403(b) plan and the defined contribution plan. However, deferrals under a governmental section 457(b) plan are not taken into account in applying this limit.

In the case of a governmental section 457(b) plan, all contributions are subject to a single limit, generally for 2014, the lesser of (1) \$17,500 plus an additional \$5,500 catch-up contribution limit for participants at least age 50 and (2) the participant's compensation. This limit is separate from the limit on elective deferrals to section 401(k) and section 403(b) plans. Thus, 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 \$17,500 (plus \$5,500 catch-up contributions if at least age 50) to the section 403(b) plan and up to \$17,500 (plus \$5,500 catch-up contributions if at least age 50) to the section 457(b) plan. In addition, under a special rule, 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. Additional contributions may be made up to the lesser of (1) two times the otherwise applicable dollar limit for the year (two times \$17,500 for 2014, or \$35,000) and (2) the participant's otherwise applicable limit for the year plus the amount by which the limit applicable to the participant for previous years exceeded the participant's deferrals for the previous years. If a higher limit applies to a participant for a year under this special rule than under the general catch-up rule, the general catch-up rule does not apply for the year.

³⁰⁸ Employee contributions to qualified defined benefit plans are also taken into account in applying this limit.

Description of Proposal

The proposal applies a single aggregate limit to contributions for a participant in a governmental section 457(b) plan and elective deferrals for the same participant under a section 401(k) plan or a 403(b) plan of the same employer. Thus, the limit for governmental section 457(b) plans is coordinated with the limit for section 401(k) and 403(b) plans in the same manner as the limits are coordinated under present law for elective deferrals to section 401(k) and section 403(b) plans.

The proposal repeals the special rules allowing additional elective deferrals and catch-up contributions under section 403(b) plans and governmental section 457(b) plans. Thus, the same limits apply to elective deferrals and catch-up contributions under section 401(k) plans, section 403(b) plans and governmental section 457(b) plans.

The proposal repeals the special rules allowing employer contributions to section 403(b) plans for up to five years after termination of employment and the special contribution rules for church employees and foreign missionaries.

The proposal also revises application of the limit on aggregate contributions to a qualified defined contribution plan or a section 403(b) plan (that is, the lesser of (1) \$52,000 (for 2014) and (2) the participant's compensation). As revised, a single aggregate limit applies to contributions for a participant to any defined contribution plans, any section 403(b) plans, and any governmental section 457(b) plans maintained by the same employer, including any members of a controlled group or affiliated service group.³⁰⁹

Effective Date

The proposal is effective for plan years and taxable years beginning after December 31, 2014.

11. Application of 10-percent early distribution tax to governmental 457 plans (sec. 1619 of the discussion draft and sec. 72(t) of the Code)

Governmental section 457(b) plans

Special rules apply with respect to deferred compensation arrangements of State and local government and tax-exempt employers.³¹⁰ Amounts deferred under an eligible deferred compensation plan, i.e., a section 457(b) plan, are not currently included in income. In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are

³⁰⁹ As under present law, employee contributions to qualified defined benefit plans are also taken into account in applying this limit.

³¹⁰ Sec. 457.

contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).³¹¹

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals (\$17,500 for 2014) and catch-up contributions (\$5,500 for 2014) under a section 401(k) plan or a section 403(b) plan, or, if less, the employee's compensation.³¹² As of 2011, a governmental section 457(b) plan may include a qualified Roth contribution program, allowing a participant to elect to have all or a portion of the participant's deferrals under the plan be treated as designated Roth contributions.

Early distribution tax

The Code imposes provides an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before employee or an IRA owner attains age 59½ unless an exception applies.³¹³ 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. This early distribution tax does not apply to distributions from governmental section 457(b) plans.

Description of Proposal

The proposal imposes the 10-percent early distribution tax on distributions from governmental section 457(b) plans.

Effective Date

The proposal is effective for distributions on or after February 26, 2014.

³¹¹ In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.

³¹² Under present law, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan. In addition, under a special catch-up rule, for one or more of the participant's last three years before normal retirement age, the otherwise applicable limit is increased to the lesser of (1) two times the normal annual limit (\$34,000 for 2012) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year. Section 1618 of the discussion draft eliminates these special rules with respect to governmental section 457(b) plans.

³¹³ Sec. 72(t).

12. Inflation adjustments for employer-sponsored retirement plan dollar limitations on benefits and contributions (secs. 1620 to 1624 of the discussion draft and secs. 402(g), 415(d), and 408(p) of the Code)

Present Law

In general

There are several types of funded tax-favored employer-sponsored retirement plans: qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, simplified employee pensions, and simple retirement plans. Tax-favored retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses. Defined contribution plans generally may provide for nonelective contributions and matching contributions by employers and elective deferrals or after-tax contributions by employees. Elective deferrals are contributions made pursuant to an election by an employee between cash compensation and a contribution to the plan. Among the requirements that apply to tax-favored qualified retirement plans are dollar limits on the benefits and contributions that are permitted to be provided under the plan.³¹⁴

The dollar limits generally are indexed to reflect cost-of-living increases. The index used for adjusting the dollar limits is generally the same index used for cost-of-living increases in Social Security benefits. An adjustment with respect to any calendar year is based on the index for the calendar quarter ending September 30 of the preceding calendar year over such index for the base period which starts from the base calendar quarter. However for each limit, there is a rounding rule under which any increase that is not a multiple of a specified dollar amount (such as \$500) is rounded down to the next lowest multiple for that dollar amount.

Qualified retirement plans and annuities

Limits on defined benefit plans

In the case of a qualified defined benefit plan, a dollar limit applies on the amount of benefits payable with respect to a participant. The dollar limit is expressed in terms of a benefit commencing at age 65 in the form of a straight life annuity for the life of the participant. The dollar limit on the annual payments under the annuity is \$210,000 a year (for 2014).³¹⁵ The limit applies to the aggregate of all benefits accrued by an employee under all defined benefit plans

³¹⁴ Generally, any limit on contributions or benefits is the lesser of a dollar limit or a percentage of the employee's compensation.

³¹⁵ Section 415(b)(1)(A). The limit is expressed as an annuity commencing at age 65, but there is no actuarial adjustment required for commencement between age 62 and 65.

maintained by the same employer.³¹⁶ This limit is only increased for cost-of-living in multiples of \$5,000.

Limits on Contribution to Defined Contribution Plans

In the case of a qualified defined contribution plan, a dollar limit applies on the amount of contributions that can be made for each employee for a year under all defined contribution plans of the same employer. The dollar limit is \$52,000 (for 2014), and generally applies to allocations to a participant's account under the terms of the plan as of any date during the year.³¹⁷ The limit is only increased for cost-of-living in multiples of \$1,000.

Elective deferrals

Certain qualified defined contribution plans ("section 401(k)" plans) include a feature under which an employee may elect to have elective deferrals made to the plan, subject to a dollar maximum. The dollar limit is \$17,500 (for 2014) and is applied to the amount of deferrals for the employee's taxable year (which is generally the calendar year).³¹⁸ Additional elective deferrals ("catch-up contributions") are allowed for employees aged 50 or older, up to a dollar limit of \$5,500 (for 2014). Both limits are only increased for cost-of-living in multiples of \$500.

Elective deferrals up to these limits are either not includable in gross income (but then subsequent distributions attributable to the contributions are includable in gross income) or are designated Roth contributions (in which case the contributions are includable in gross income but then subsequent qualified distributions attributable to the Roth contributions are excludable from gross income).

The amount of elective deferrals (but not catch up contributions) is also included in the contributions subject to the general limit (\$52,000 for 2014).

Section 403(b) plans

Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations,³¹⁹ and (2) educational institutions of State or local governments (i.e., public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of

³¹⁶ In applying the limits under both defined benefit plans and defined contributions plans, and the qualification requirement generally to a plan, the members of a control group as determined under section 414(b), (c), (m), and (o) are treated as a single employer.

³¹⁷ Sec. 415(c)(1)(A). Employee contributions to a defined benefit plan are also taken into account for purposes of this limit.

³¹⁸ Sec. 402(g).

³¹⁹ Sec. 501(c)(3).

their employees, and the plan may provide for employees to make pretax elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the general limit on contributions (\$52,000 for 2014) and the special limits for elective deferrals (\$17,500 for 2014) and catch-up contributions (\$5,500 for 2014) under a section 401(k) plan. If elective deferral and catch-up contributions are made to both a section 401(k) plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans.³²⁰

Governmental section 457(b) plans

Deferrals under a governmental section 457(b) plan are generally subject to the same limits as elective deferrals (\$17,500 for 2014) and catch-up contributions (\$5,500 for 2014) under a section 401(k) plan or a section 403(b) plan. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan.³²¹

Employer-sponsored retirement plans using IRAs

SIMPLE IRA plan

An employer that employs no more than 100 employees who earned \$5,000 or more during the prior calendar year can establish a simple retirement plan, under which an IRA is established for each employee (that is, a SIMPLE IRA). A SIMPLE IRA plan allows employees to make elective deferrals, but is subject to a special limit, \$12,000 (for 2014).³²² The catch-up contribution limit for an individual age 50 or over is \$2,500 (for 2014). Both limits are only increased for cost-of-living in multiples of \$500.

Simplified employee pension plan

A simplified employee pension (“SEP”) is a type of employer-sponsored retirement plan under which an employer may make contributions to a SEP IRA for each eligible employee up to the lesser of 25 percent of the employee’s compensation or the dollar limit applicable to contributions to a qualified defined contribution plan (\$52,000 for 2014).

³²⁰ Any elective deferrals under SIMPLE IRAs and SARSEPs (discussed below) are also taken into account for purposes of this single limit.

³²¹ This separate application of the deferral limit for governmental section 457(b) plans is eliminated by section 1618 of the discussion draft.

³²² There is also a type of simple retirement plan that is a form of section 401(k) plan (“SIMPLE 401(k) plan”) under which elective deferrals and catch up contributions are also subject to this lower limit. Section 1612 of the discussion draft provides that no new SIMPLE 401(k) plans may be established.

Certain SEP plans established before 1997 may include a salary reduction feature (“SARSEP”) under which employees can make elective deferrals. Elective deferrals under a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan (\$17,500, plus catch-up contribution up to \$5,500 for a participant age 50 or over, for 2014).

Description of Proposal

The proposal suspends the adjustments for cost of living on tax-favored retirement plan dollar limits and holds these limits at the 2014 level through 2023. Thus, through 2023, the defined benefit plan dollar limit remains at an annuity with annual payments equal to \$210,000 commencing at age 65; the defined contribution plan dollar limit remains at \$52,000; the elective deferral dollar limit remains at \$17,500; and the catch-up contribution dollar limit remains at \$5,500. The dollar limit on deferral limits under section 457(b) plans also remains at \$17,500 and the limit on catch-up contributions for these plans remains at \$5,500. Similarly, the limit on elective deferrals under simple retirement plans remains at \$12,000 and the limit on catch up contributions for simple retirement plans remains at \$2,500. Adjustments resume in 2024 using the quarter beginning July 1, 2022 as the base calendar quarter.

Effective Date

The suspension of adjustments to the defined benefit plan dollar limit and the defined contribution plan dollar limit applies to years ending with or within a calendar year beginning after 2014. The suspension of the adjustment to the elective deferral dollar limit applies to plan years and taxable years beginning after December 31, 2014. The suspension of the adjustments to dollar limit on elective deferrals under simple retirement plans is effective for calendar years beginning after 2014. The proposal otherwise applies to taxable years beginning after December 31, 2014.

H. Certain Provisions Related to Members of Indian Tribes

1. Indian general welfare benefits (secs. 1701-1703 of the discussion draft and new sec. 139E of the Code)

Present Law

Except as otherwise provided, gross income means all income from whatever source derived. The general welfare doctrine is an IRS administrative rule that operates to exclude certain payments from gross income. Excludable payments generally consist of payments: (i) made from a governmental fund, (ii) for the promotion of general welfare (on the basis of the need of the recipient), and (iii) which do not represent compensation for services. Examples of excludable benefits include disaster relief, adoption assistance, housing and utility subsidies for low income persons, and government benefits paid to the blind.

Prior to IRS Notice 2012-75 (the “Notice”),³²³ there was some uncertainty concerning the application of the general welfare doctrine to certain benefits provided by Indian tribes to their members. Benefits that have been scrutinized by the IRS include payments for housing, cultural, education, and elder programs provided by Indian tribal governments. The issue is whether the tribal governments can provide such benefits tax-free to their members because they are addressing a social welfare need, without considering the financial need of the members.

In response to requests from tribes to provide guidance on this issue, the IRS has issued the Notice, which provides safe harbors under which the IRS presumes that the individual need requirement of the general welfare exclusion is met for benefits provided under certain Indian tribal governmental programs.

Description of Proposal

The proposal contains similar requirements to the Notice under which benefits would qualify for exclusion from income under the general welfare doctrine, including that the benefits (i) are provided pursuant to a specific Indian tribal government program, (ii) are available to any tribal member who meets certain guidelines, (iii) are for the promotion of general welfare, (iv) are not lavish or extravagant, and (v) are not compensation for services.

The proposal requires the Secretary of the Treasury (“Secretary”) to establish a Tribal Advisory Committee to advise on matters relating to the taxation of Indians. In consultation with the Committee, the proposal requires the Secretary to establish and require training of IRS agents on Federal Indian law and training of tribal financial officers about the proposal. The proposal also requires the Secretary to suspend audits and examinations of Indian tribal governments and tribe members relating to the general welfare exclusion until this education has been completed. The proposal allows the Secretary to waive interest and penalties to the extent those penalties relate to excluding a payment under the general welfare exclusion.

³²³ Notice 2012-75, 2012-51 I.R.B. 715, December 17, 2012.

The proposal applies to years for which the tribal member's refund statute of limitation period has not expired and provides a one-year waiver of the refund statute of limitations period in the event that the period expires before the end of the one-year period beginning on the date of enactment of the Act.

Effective Date

The proposal is effective on the date of enactment.