Congressional Research Service
Informing the legislative debate since 1914

# Selected Recently Expired Business Tax Provisions ("Tax Extenders")

**Jane G. Gravelle**
Senior Specialist in Economic Policy

**Donald J. Marples**
Specialist in Public Finance

**Molly F. Sherlock**
Coordinator of Division Research and Specialist

July 17, 2015

**Congressional Research Service**
7-5700
www.crs.gov
R43510

**CRS REPORT**
Prepared for Members and
Committees of Congress

# Summary

The Tax Increase Prevention Act of 2014 (P.L. 113-295), signed into law on December 19, 2014, made tax provisions that had expired at the end of 2013 available to taxpayers for the 2014 tax year. The law extended most (but not all) provisions that had expired at the end of 2013. Several bills have been considered in the 114th Congress to make some provisions permanent, including the R&E tax credit (H.R. 880), expensing of investments (S. 636, S. 1399), and treatment of built-in gains for Subchapter S corporations (S. 636). This report briefly summarizes and discusses the economic impact of selected business-related tax provisions that expired at the end of 2014.

The provisions discussed in this report include three employer-related benefits:

- Work Opportunity Tax Credit
- Indian Employment Tax Credit
- Employer Wage Credit for Activated Military Reservists

Two international provisions that provide exceptions from the Subpart F rules are discussed:

- Look-Through Treatment of Payments between Related Controlled Foreign Corporations under the Foreign Personal Holding Company Rules
- Exceptions under Subpart F for Active Financing Income

Seven special business cost recovery provisions are discussed:

- Bonus Depreciation
- Increase in Expensing to $500,000/$2,000,000 and Expansion of Definition of Section 179 Property
- Special Expensing Rules for Certain Film and Television Productions
- 15-Year Straight-Line Depreciation Provisions
- 7-Year Recovery Period for Motorsports Entertainment Complexes
- 3-Year Depreciation for Race Horses Two Years Old or Younger
- Accelerated Depreciation for Business Property on an Indian Reservation

Two provisions related to regulated investment companies (RICs) are discussed:

- Treatment of Certain Dividends of RICs
- RIC Qualified Investment Entity Treatment under the Foreign Investment in Real Property Act (FIRPTA)

And eight other business-related provisions are also discussed:

- Tax Credit for Research and Experimentation Expenses
- Credit for Certain Expenditures for Maintaining Railroad Tracks
- Reduction in S-Corporation Recognition Period for Built-In Gains

- Election to Accelerate AMT Credits in Lieu of Additional First-Year Depreciation
- Temporary Increase in Limit on Cover Over of Rum Excise Tax Revenues to Puerto Rico and the Virgin Islands
- 100% Exclusion for Qualified Small Business Stock
- Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico
- Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations

This report does not include provisions that in the past have been classified as charitable, community development, individual, or housing-related provisions. These provisions are included in the following CRS reports:

- CRS Report R43517, *Recently Expired Charitable Tax Provisions ("Tax Extenders"): In Brief*, by Jane G. Gravelle and Molly F. Sherlock
- CRS Report R43541, *Recently Expired Community Assistance-Related Tax Provisions ("Tax Extenders"): In Brief*, by Sean Lowry
- CRS Report R43688, *Selected Recently Expired Individual Tax Provisions ("Tax Extenders"): In Brief*, by Jane G. Gravelle
- CRS Report R43449, *Recently Expired Housing Related Tax Provisions ("Tax Extenders"): In Brief*, by Mark P. Keightley

# Contents



# Tables



# Contacts

# Introduction

The Tax Increase Prevention Act of 2014 (P.L. 113-295), signed into law on December 19, 2014, made tax provisions that had expired at the end of 2013 available to taxpayers for the 2014 tax year. The law extended most (but not all) provisions that had expired at the end of 2013. This report briefly summarizes and discusses the economic impact of selected business-related tax provisions that expired at the end of 2014 and may be considered for extension.[1]

The provisions discussed in this report include several employer-related benefits, international provisions that provide exceptions to the Subpart F rules, special cost recovery provisions, provisions related to regulated investment companies (RICs), as well as several other business-related provisions. A complete list of the provisions discussed in this report can be found in **Table 1**.

Extending expiring provisions retroactively for one year, as was done in the Tax Increase Prevention Act of 2014, cost $41.6 billion over the 10-year budget window.[2] More than half of this cost ($22.3 billion) is from the extension of business-related provisions discussed in this report. The tax extender provision with the largest cost was tax credit for research and experimentation expenditures. The one-year extension enacted late in the 113th Congress cost $7.6 billion. **Table 1** provides information on the revenue cost of the one-year extension enacted as the Tax Increase Prevention Act of 2014.

In recent years, the House has considered legislation to make permanent certain business-related extender provisions. In the 114th Congress, America's Small Business Tax Relief Act of 2015 (H.R. 636), which passed the House on April 13, 2015, would make Section 179 expensing and the treatment of built-in gains of Subchapter S corporations permanent. The American Research and Competitiveness Act of 2015 (H.R. 880), which would expand and make permanent the R&E tax credit, was passed in the House on May 20, 2015. Legislation to make certain business-related extender provisions permanent was also considered in the 113th Congress. On September 18, 2014, the House passed the Jobs for America Act (H.R. 4), which would have made permanent five of the expired provisions discussed in this report (see **Table 1**).[3] The cost of making permanent these five provisions is $499.3 billion over the 10-year budget window. The total cost estimate for H.R. 4, which also includes a repeal of the medical device tax[4] and the Save American Workers Act of 2014 (H.R. 2575), was $572.2 billion over the 10-year budget window.

[1] For a general overview of "tax extenders," see CRS Report R43898, *Tax Provisions that Expired in 2014 ("Tax Extenders")*, by Molly F. Sherlock.

[2] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 113th Congress, April 1, 2015, JCS-1-15, https://www.jct.gov/publications.html?func=startdown&id=4741

[3] This report does not include a discussion of the temporary rules regarding basis adjustments to stock of S corporations making charitable contributions of property, which also would be made permanent in H.R. 4.

[4] For more information, see CRS Report R43342, *The Medical Device Excise Tax: Economic Analysis*, by Jane G. Gravelle and Sean Lowry.

**Table 1. Cost of Extending Certain Expired Provisions**

billions of dollars

| Provision | 10-Year Cost of Extension through 2014 in P.L. 113-295 | 10-Year Cost of Permanent Extension | Permanent Extension Passed in the House (114th Congress) |
|---|---|---|---|
| **Employment-Related Provisions** | | | |
| Work Opportunity Tax Credit | $1.4 | $16.4 | |
| Indian Employment Tax Credit | $0.1 | $0.7 | |
| Employer Wage Credit for Activated Military Reservists | -i- | -i- | |
| **International Provisions** | | | |
| Look-Through Treatment of Payments between Related Controlled Foreign Corporations under the Foreign Personal Holding Company Rules | $1.2 | $20.3[a] | [a] |
| Exceptions under Subpart F for Active Financing Income | $5.1 | $58.8[a] | [a] |
| **Cost Recovery Provisions** | | | |
| Bonus Depreciation | $1.2 | $244.7 | [b] |
| Increase in Expensing to $500,000/$2,000,000 and Expansion of Definition of Section 179 Property | $1.4 | $77.1 | H.R. 636[b] |
| Special Expensing Rules for Certain Film and Television Productions | -i- | $1.3 | |
| 15-Year Straight-Line Depreciation Provisions | $2.4 | $16.2 | |
| 7-Year Recovery Period for Motorsports Entertainment Complexes | -i- | $0.6 | |
| 3-Year Depreciation for Race Horses Two Years Old or Younger | — | $0.5 | [c] |
| Accelerated Depreciation for Business Property on an Indian Reservation | $0.1 | $1.4 | |
| **Regulated Investment Company Provisions** | | | |
| Treatment of Certain Dividends of Regulated Investment Companies (RICs) | $0.1 | $1.3 | |
| RIC Qualified Investment Entity Treatment under FIRPTA | -i- | $0.7 | |

| Provision | 10-Year Cost of Extension through 2014 in P.L. 113-295 | 10-Year Cost of Permanent Extension | Permanent Extension Passed in the House (114th Congress) |
|---|---|---|---|
| **Other Provisions** | | | |
| Tax Credit for Research and Experimentation Expenses | $7.6 | $181.6[d] | H.R. 880[b] |
| Credit for Certain Expenditures for Maintaining Railroad Tracks | $0.2 | $2.1 | |
| Reduction in S-Corporation Recognition Period for Built-In Gains | $0.1 | $1.5 | H.R. 636[b] |
| Election to Accelerate AMT Credits in Lieu of Additional First-Year Depreciation | $0.3 | $24.5 | [b] |
| Temporary Increase in Limit on Cover Over of Rum Excise Tax Revenues to Puerto Rico and the Virgin Islands | $0.2 | n.a. | |
| 100% Exclusion for Qualified Small Business Stock | $0.9 | $9.2 | |
| Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico | $0.1 | $2.1 | |
| Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations | -i- | $0.2 | |

**Source:** Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 113th Congress, April 1, 2015, JCS-1-15, https://www.jct.gov/publications.html?func=startdown&id=4741; Congressional Budget Office, The Budget and Economic Outlook: 2014 to 2024, Washington, DC, February 4, 2014, http://www.cbo.gov/publication/45010; and Joint Committee on Taxation, Estimated Revenue Effects of Division I of H.R. 4, the "Jobs for America Act," Scheduled for Consideration by the House of Representatives, 113th Cong., September 17, 2014, JCX-105-14, https://www.jct.gov/publications.html?func=startdown&id=4672.

**Notes:** An -i- indicates a revenue cost of less than $50 million. An entry of "n.a." indicates that the estimate was not available.

a. On April 29, 2014, the House Committee on Ways and Means voted to report legislation that would make permanent the subpart F exemption for active financing income (H.R. 4429) and the look-through treatment of payments between related controlled foreign corporations (H.R. 4464). This revenue estimate was prepared by the JCT in advance of the April 29, 2014, markup considering permanent extension of this provision. JCT's revenue estimates are available at https://www.jct.gov/publications.html.

b. This provision was included in the Jobs for America Act (H.R. 4), which was passed in the House in the 113th Congress. Joint Committee on Taxation, Estimated Revenue Effects of Division I of H.R. 4, the "Jobs for America Act," Scheduled for Consideration by the House of Representatives, 113th Cong., September 17, 2014, JCX-105-14, https://www.jct.gov/publications.html?func=startdown&id=4672.

c. This provision would have been made permanent in House Ways and Means Committee Chairman Dave Camp's Tax Reform Act of 2014 (H.R. 1).

d. Under the House-passed proposal (H.R. 880), the credit would be equal to the sum of 20% of a taxpayer's qualified research expenditures (QREs) in the current tax year above 50% of average annual QREs in the previous three tax years, 20% of its basic research payments in the current tax year above 50% of average annual basic research payments in the three previous tax years, and 20% of the amounts paid or incurred by the taxpayer in the current tax year for qualified energy research conducted by an energy research consortium. For more information, see CRS Report RL31181, *Research Tax Credit: Current Law and Policy Issues for the 114th Congress*, by Gary Guenther.

During the 113th Congress, the House Committee on Ways and Means also reported legislation that would have permanently extended two other expiring provisions. H.R. 4429 would have amended the Internal Revenue Code of 1986 to permanently extend the subpart F exemption for active financing income and H.R. 4464, to make permanent the look-through treatment of payments between related controlled foreign corporations. These measures did not pass the House.

The President's FY2016 budget identifies several expiring provisions that should be permanently extended (and in some cases substantially modified). Specifically, the provisions addressed in the President's FY2016 budget include (1) the increased expensing for certain businesses under Section 179; (2) the 100% exclusion for qualified small business stock; (3) the research and experimentation (R&E) tax credit; and (4) certain employment-related credits (the Work Opportunity Tax Credit (WOTC) and the Indian employment credit). The President's budget also proposes permanently extending the exception under Subpart F for active financing income and the look-through treatment of payments between related controlled foreign corporations (CFCs) as part of a broader reform to the U.S. international tax system.

For certain cost recovery provisions, the 10-year revenue cost of a permanent extension is substantially greater than the cost of temporarily extending the provision. For example, the revenue cost of temporarily extending bonus depreciation for one year, through 2014, was $1.2 billion. Making bonus depreciation permanent would cost $244.7 billion. This estimate is likely reduced, relative to a stand-alone provision, due to interaction effects with other provisions, most notably Section 179.[5] For example, it was estimated that a permanent extension, as proposed in H.R. 4718 in the 113th Congress, would have cost $263 billion over 10 years.[6] With a temporary extension, tax liability is deferred, with much of the cost recovered in the later years in the budget window. A similar pattern is observed for the proposed increase in the Section 179 expensing allowances, with a temporary one-year extension having cost an estimated $1.4 billion. A permanent extension, however, would cost $77.1 billion over the 10-year budget window.

This report does not include provisions that in the past have been classified as charitable, community development, individual, or housing-related provisions. These provisions are included in the following CRS reports:

- CRS Report R43517, *Recently Expired Charitable Tax Provisions ("Tax Extenders"): In Brief*, by Jane G. Gravelle and Molly F. Sherlock;
- CRS Report R43541, *Recently Expired Community Assistance-Related Tax Provisions ("Tax Extenders"): In Brief*, by Sean Lowry;
- CRS Report R43688, *Selected Recently Expired Individual Tax Provisions ("Extenders"): In Brief*, by Jane G. Gravelle; and
- CRS Report R43449, *Recently Expired Housing Related Tax Provisions ("Tax Extenders"): In Brief*, by Mark P. Keightley.

---

[5] These interactions (commonly referred to as stacking) are a feature of revenue estimation. See Joint Committee on Taxation, The JCT Revenue Estimating Process, January 2013, at https://www.jct.gov/publications.html?func=download&id=4500&chk=4500&no_html=1.

[6] See Joint Committee on Taxation, Estimated Revenue Effects Of H.R. 4718, Scheduled For Consideration By The House Of Representatives on July 11, 2014, JCX-86-14, July 11, 2014, at https://www.jct.gov/publications.html?func=startdown&id=4651.

# Employment-Related Provisions

Tax incentives have been used at the federal level to encourage employers to hire employees from certain groups or to encourage employers to provide certain forms of compensation or benefits. The first two credits discussed below, the work opportunity tax credit (WOTC) and the Indian employment tax credit, encourage employers to hire selected types of employees. The third provision, the employer wage credit for employees on active military duty, encourages employers to provide "differential pay" to employees whose military pay is less than their civilian salary.

## Work Opportunity Tax Credit[7]

The work opportunity tax credit (WOTC) is a non-refundable wage credit intended to increase job opportunities for certain categories of disadvantaged individuals. The WOTC reduces the cost of hiring specified groups of disadvantaged individuals. WOTC-eligible hires include members of families receiving Temporary Assistance to Needy Families (TANF) benefits, certain members of families receiving food stamp benefits, ex-felons, and certain veterans.

For most eligible hires that remain on a firm's payroll at least 400 hours, an employer can claim an income tax credit equal to 40% of wages paid during the worker's first year of employment, up to a statutory maximum. For most WOTC-eligible hires, the wage maximum is $6,000, for a maximum credit of $2,400. For eligible veterans, the maximum eligible wage varies between $6,000 and $24,000, depending on the veteran's characteristics and work history. Eligible summer youth hires' maximum wage to which the credit can be applied is $3,000. A credit equal to 25% of a qualified worker's wages is available for eligible hires that remain employed for at least 120 hours, but fewer than 400 hours.

The WOTC was created as part of the Small Business Job Protection Act of 1996 (P.L. 104-188). The WOTC evolved from an earlier tax credit designed to increase employment among targeted groups, the Targeted Jobs Tax Credit (TJTC), which was available from 1978 through 1994. When first enacted, the WOTC was scheduled to expire on October 1, 1997. Since 1997, the WOTC has been expanded, modified, and regularly extended. In several instances, the WOTC was allowed to lapse before being retroactively reinstated.

The WOTC is designed to encourage employers to hire more disadvantaged individuals by compensating for potential higher costs of training and possible lower productivity. Since the credit is focused on hiring from targeted groups, and not net job creation, the credit is not necessarily intended to create new jobs or promote recovery in labor markets.[8] Studies evaluating the credit have looked at whether the credit increases job opportunities for targeted disadvantaged individuals, and whether the WOTC is a cost-effective policy measure for achieving this objective.

Early evidence on the WOTC suggested that while the credit did offset part of the cost of recruiting, hiring, and training WOTC-eligible employees, it had a limited effect on companies'

[7] Internal Revenue Code (IRC) Section 51(c)(4).

[8] Kenneth A. Couch, Douglas J. Besharov, and David Neumark, "Spurring Job Creation in Response to Severe Recessions: Reconsidering Hiring Credits," *Journal of Policy Analysis and Management*, vol. 32, no. 1 (Winter 2013), pp. 142-171.

hiring decisions.[9] More recent studies have found that the WOTC provided benefits to certain groups: increasing the wage income of disabled veterans and increasing employment among long-term welfare recipients, for example. Researchers have also explored whether the credit causes employers to "churn" their workforce in order to take advantage of the credit, replacing currently credit-ineligible workers with credit-certified workers. Evidence of this behavior has not been found.

For more information on the WOTC, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by Christine Scott, available upon request.

## Indian Employment Tax Credit[10]

The Indian employment tax credit is an incremental credit claimed by employers for qualified wages and health insurance costs. Similar to the WOTC, the Indian employment credit is designed to encourage hiring of certain individuals—enrolled members of an Indian tribe and their spouses. There are also restrictions limiting the benefit to services performed within an Indian reservation for individuals living on or near the reservation.

The Indian employment credit is 20% of the excess of qualified wages and health insurance costs over base year expenses, paid by an employer. The credit is allowed for the first $20,000 in qualified wages and health insurance costs. The base year is 1993, such that the incentive is incremental to 1993 wages and health insurance costs (the base year has not been changed since the credit was enacted). The credit is not available for wages paid to an employee whose total wages exceed $30,000, as adjusted for inflation ($45,000 in 2013). The employer must reduce their deduction for wages by the amount of the credit.

The Indian employment credit was first enacted in 1993, as part of the Omnibus Reconciliation Act of 1993 (P.L. 103-66). It was initially scheduled to expire at the end of 2003, but has been regularly extended, often retroactively. Past extensions of the Indian employment credit have extended the termination date without updating the base year. Some have proposed updating the base year, in an effort to (1) eliminate the need for taxpayers to maintain tax records dating back to 1993, and (2) restore the incremental design of the credit.[11]

Extending the Indian employment credit might encourage additional hiring of Indian tribe members and their spouses. Similar to the WOTC, while the Indian employment credit may not increase overall employment on or near Indian reservations, it might increase employment among tribe members.

---

[9] For an overview of the empirical literature on the WOTC, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by Congressional Research Service, 113th Cong., December 2014, S. Prt. 113-32, pp. 753-762, available at: http://www.crs.gov/Products/CommitteePrint/CP10001.pdf.

[10] IRC Section 45A(f).

[11] See, for example, Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, Washington, DC, February 2015, pp. 51-53, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

## Employer Wage Credit for Activated Military Reservists[12]

Members of the National Guard or Reserves who are called up to active duty receive military pay. Some National Guard or Reserves members may have civilian salaries higher than their military pay. Civilian employers might choose to compensate employees for the reduction in salary that results from being called up to active duty. This form of compensation is often called differential pay. Certain small businesses may qualify for a tax credit to offset some of the costs associated with providing these military pay differentials.

Under this provision, eligible small businesses can claim a 20% tax credit for differential wage payments made to National Guard or Reserves members who are on active duty for more than 30 days. Eligible small businesses are those with fewer than 50 employees that provide differential wage payments to every qualified employee under a written plan. Eligible differential wage payments cannot exceed $20,000 per year, meaning the maximum value for the tax credit is $4,000 (20% of $20,000) per employee.

The employer wage credit for employees on active military duty was added to the code as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245). The provision, which was set to expire at the end of 2009, has been extended multiple times as part of past "tax extenders" legislation.

Employers that offer differential pay do so voluntarily. Reasons employers may choose to offer differential pay include a show of patriotism or support for troops, or an effort to retain employees after their military duty ends. There is a perception that small businesses may be less able to offer differential pay than larger firms. This provision, by reducing the net cost of providing differential pay for small businesses, should increase the total amount of differential pay being provided by small businesses. If the goal of the provision is to provide income support to National Guard or Reserve members called up to active duty, one might question why the incentive is limited to employers with fewer than 50 employees.

Not all employees called up to active duty will necessarily be eligible to receive differential pay. Since differential pay is the difference between an individual's civilian salary and military salary, many middle-income individuals will not receive differential pay, as their military salaries are at least equal to their civilian salary. Lower-income individuals usually receive a higher military than civilian salary. Thus, the tax benefit tends to favor employers of middle- to higher-wage earners employed by qualified small businesses. Businesses employing middle- to lower-income wage earners may not have the opportunity to provide differential pay (if their employee's military pay is equal to or greater than their civilian pay), but may face other burdens when employees are called up to active duty (e.g., workforce disruptions).

# International Provisions

In general, income earned abroad by foreign incorporated subsidiaries is not taxed until it is repatriated (paid to the U.S. parent as a dividend).[13] Foreign subsidiaries are not allowed to

[12] IRC Section 45P.

[13] For general background on international tax issues, see CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle and CRS Report R42624, *Moving to a Territorial Income Tax: Options and* (continued...)

circumvent this tax by making other payments to the parent such as loans. The tax due on repatriated income is offset by credits for foreign income taxes paid. For passive income (such as interest income) and certain types of payments which can be easily manipulated to reduce foreign taxes, tax rules require this income to be taxed currently (referred to as Subpart F income to indicate where in the code its tax treatment is specified). The two international provisions in the extenders package provide exceptions from the Subpart F rules.

## Look-Through Treatment of Payments between Related Controlled Foreign Corporations under the Foreign Personal Holding Company Rules[14]

Unless an exception applies, Subpart F income includes dividends, interest, rent, and royalty payments between related firms. These items of income are subject to Subpart F because affiliated firms can use them to shift income and avoid tax. For example, without Subpart F a U.S. parent's subsidiary (1st tier subsidiary) in a country without taxes (e.g., the Cayman Islands) could lend money to its own subsidiary (2nd tier subsidiary) in a high tax country. The interest payments would be deductible in the high tax country, but no tax would be due in the no-tax country. Thus, an essentially paper transaction shifts income out of the high tax country. A similar effect might occur if an intangible asset is transferred to the no-tax subsidiary, and then licensed in exchange for a royalty payment by the high tax subsidiary.

In some cases, a U.S.-based multinational firm might be able to avoid having the earnings of a foreign subsidiary classified as Subpart F income if the high tax (2nd tier) subsidiary could be treated as an unincorporated entity for U.S. tax purposes. This is not feasible for some businesses that are required, by foreign law, to operate as what are for U.S. tax purposes *per se* corporations, or those that would face complex challenges and costs in changing their structure.

Methods of avoiding Subpart F taxation were made easier in 1997, when U.S. entity classification rules (to be a corporate or non-corporate entity) were simplified by simply checking a box on a form. These "check-the-box" regulations provided a way to avoid treatment of payments as Subpart F income under certain circumstances by allowing firms to elect treatment as an unincorporated entity. They were originally intended to simplify classification issues for domestic firms and the IRS, but their usefulness in international tax planning quickly became evident. The Treasury issued regulations in 1998 to disallow their use to avoid Subpart F,[15] but, after protests from firms and from Congress, withdrew them.

In the example above, if the high-tax subsidiary is not a direct subsidiary of the U.S. parent but is a subsidiary of the Cayman Islands subsidiary (i.e., a 2nd tier subsidiary), the Cayman Islands (1st tier) subsidiary can elect to treat the high-tax subsidiary as if it were a pass through entity. This treatment would effectively combine the two subsidiaries into a single firm. This outcome can be achieved simply by checking a box, making the high tax subsidiary a disregarded entity under

(...continued)

*Challenges*, by Jane G. Gravelle.

[14] IRC Section 954(c)(6).

[15] Notice 98-11, January16, 1998, http://www.irs.gov/pub/irs-drop/n-98-11.pdf.

U.S. law. Because there are no separate firms, no income is recognized by the Cayman Islands firm although the high tax subsidiary (2nd tier) is still a corporation from the point of view of the foreign jurisdiction in which it operates and can deduct interest in the high tax jurisdiction.

The check-the-box rules did not work in every circumstance. For example, if the related firms did not have the same 1st tier parent, check-the-box did not apply. In some cases, because of foreign countries' rules about corporate and non-corporate forms, the check-the-box regulations' classification of some entities as *per se* corporations made this planning unavailable. In addition, other undesirable tax consequences (from the firm's point of view) could occur as a side effect of check-the-box.

The look-through rule effectively puts this check-the-box type of planning into the tax code, rather than as a regulation (which could be altered without legislation), but disconnects it from the regulations' creation of a disregarded entity. Related firms do not have to have the parent-child relationship; they can be otherwise related as long as they are under common control.

The look-through rules were originally enacted in the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222), for 2006 through 2008, and subsequently extended.

The main argument against the look-through rules (and check-the-box as well) is that it undermines the purpose of Subpart F, which is to prevent firms from using passive and easily shifted income to avoid tax. The rules also provide a way to shift and reinvest excess foreign earnings among distantly related operations, or to shift earnings to a tax haven, without first repatriating them to the U.S. parent. This is done by paying dividends directly to related foreign subsidiaries of their parent. Thus, it increases the disincentive to repatriate earnings.

The main argument for the provision is to allow firms the flexibility to redeploy earnings from one location to another without having U.S. tax consequences (foreign tax rules are unchanged). Firms could, for example, accomplish much of the treatment of look-through rules (even in the absence of check-the-box), but that may involve complex planning and inconvenience. An argument can also be made that in some cases (for example, with the payment of interest), the profit shifting is not harming the U.S. Treasury, but rather reducing taxes collected by foreign governments. If profits are shifted to low-tax countries and then eventually repatriated, foreign tax credits will be smaller, and the U.S. tax collected higher (although deferred). At the same time, this planning achieves lower effective foreign taxes in countries with relatively high nominal tax rates and, as a result, encourages investment in those countries compared to the United States.

## Exceptions under Subpart F for Active Financing Income[16]

The Taxpayer Relief Act of 1997 (P.L. 105-34) contained a temporary exception from subpart F income tax rules for active financing income. Active financing income applies to some of the income earned by American corporations from the active conduct of a banking, financing, or insurance business abroad. This income—which includes dividends and capital gains—would otherwise be taxed under Subpart F as passive income. The tax expenditure is therefore the

[16] IRC Sections 953(e), 954(h)(9), and 954(i).

allowance of deferral for this income. Since being enacted in 1997, the temporary provision providing an exception under Subpart F for active financing income has regularly been extended.

The original enactment of Subpart F in 1962 had an exception for banking and insurance. The rationale for this exception was that such income (e.g., interest and dividends) was not passive income in the hands of banking and insurance firms. The Tax Reform Act of 1986 (P.L. 105-34) eliminated the exception, because firms could locate profits in tax havens that have little economic substance. President Clinton applied a line-item veto to this provision when enacted in 1997, but the line-item veto was subsequently found unconstitutional.

Industry advocates argue that the purpose of the active financing exception may be to place U.S. financial services businesses on similar footing to their competitors from other countries. Conversely, passive income could be viewed as passive regardless of the underlying businesses. The provision does provide an incentive for U.S. financial service businesses to invest in low-tax countries (as high foreign taxes generally negate the tax benefit provided by deferral). Today, some U.S. corporations not traditionally thought of as providing financial services may, in fact, have significant financial service operations through their subsidiaries.

# Cost Recovery Provisions

The cost of assets that provide services over a period of time, such as machines or buildings, is deducted over a period of years as depreciation. The schedule of depreciation deductions depends on the life of the asset and the distribution of deductions over that life. Straight-line depreciation is used for structures, where equal amounts are deducted in each year. For equipment, deductions are accelerated with larger amounts deducted in earlier years. Equipment is most commonly depreciated over 5 or 7 years, but some short-lived assets are depreciated over 3 years and some longer-lived assets are depreciated over 10, 15, or 20 years. Non-residential structures are depreciated over 39 years. Aside from the desire for economic stimulus, traditional economic theories suggest that tax depreciation should match as closely as possible economic (physical) depreciation of assets.

The depreciation provisions discussed below all allow earlier deductions for depreciation, which are valuable because of the time value of money. Expensing provisions allow a firm to deduct the cost of an asset the year it is placed in service.

## Bonus Depreciation[17]

Bonus depreciation has allowed firms to deduct part of the cost of equipment (most recently, 50%) in the year it was placed into service, rather than recover the cost over a period of time. Bonus depreciation was intended for a specific, short-term purpose: to provide an economic stimulus during a recession. Most economic stimulus provisions enacted in response to the recent economic slowdown have been allowed to expire.

Bonus depreciation was introduced on two occasions: in 2002 (The Job Creation and Worker Assistance Act of 2002, P.L. 107-147) and 2008 (the Economic Stimulus Act of 2008, P.L. 110-

[17] IRC Section 168(k).

185). The 2002 stimulus was allowed to expire as planned. Thus, bonus depreciation, unlike most other expiring provisions, has not been continuously extended (and therefore might not be regarded as a traditional "extender"). Regardless, the bonus depreciation introduced in 2008 was in place for seven years (through 2014), although its size varied over that period.

The analysis of bonus depreciation differs for a temporary stimulus provision, compared to a permanent provision that can affect the size and allocation of the capital stock. A temporary investment subsidy is expected to be more effective than a permanent one for the purpose of short-term stimulus, encouraging firms to invest while the benefit was in place. Its temporary nature is critical to its effectiveness. Yet, research suggests that bonus depreciation was not very effective, and probably less effective than the other tax cuts or spending increases that have now lapsed.[18]

As a permanent provision, bonus depreciation benefits equipment investments which already are favored over structures, contributing to lower effective tax rates and, in some cases, negative tax rates. Compared to a statutory corporate tax rate of 35%, bonus depreciation lowers the effective tax rate for equipment from an estimated 26% rate to a 15% rate.[19] Buildings are taxed approximately at the statutory rate. Total effective tax rates for corporate assets would be slightly higher because of stockholder taxes. Because interest payments are deducted, effective tax rates with debt financing can be negative. For assets that would be taxed at the firm's effective rate of 35% if they were equity assets (such as buildings), the effective tax rate on debt financed investment is negative 5%. The rate on equipment without bonus depreciation is negative 19%, but with bonus depreciation it is negative 37%.[20] If bonus depreciation were made permanent, U.S. effective tax rates on equipment would be significantly lower than the OECD average.[21]

The usual extenders cost a fraction of the cost of permanent provisions in a ten-year budget window, but bonus depreciation is a smaller fraction because it is a timing provision. For example, a two year extension costs $2.9 billion between 2014 and 2024, less than 1% of the cost of $296.4 billion for a permanent provision.

For more information, see CRS Report R43432, *Bonus Depreciation: Economic and Budgetary Issues*, by Jane G. Gravelle and CRS Report RL31852, *The Section 179 and Bonus Depreciation Expensing Allowances: Current Law and Issues for the 114th Congress*, by Gary Guenther.

[18] See Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2012 and 2013*, Washington, DC, November 15, 2011, http://www.cbo.gov/publication/42717. A review of the evidence is provided in CRS Report R43432, *Bonus Depreciation: Economic and Budgetary Issues*, by Jane G. Gravelle.

[19] For calculations and comparisons, see CRS Report R43432, *Bonus Depreciation: Economic and Budgetary Issues*, by Jane G. Gravelle.

[20] Ibid. When an investment is debt financed, the tax savings from the interest deductions more than offset tax due (in present value terms) on the earnings from the investment, and if the offset is large enough, it also offsets the tax on interest receive by the creditor. For a large share of investments the creditor is tax exempt (e.g., a pension fund or an IRA account).

[21] For calculations and comparisons, see CRS Report R43432, *Bonus Depreciation: Economic and Budgetary Issues*, by Jane G. Gravelle.

## Increase in Expensing to $500,000/$2,000,000 and Expansion of Definition of Section 179 Property[22]

This provision allows firms to expense (deduct immediately), with dollar limits, the cost of investment in equipment. In 2014, this amount was $500,000. Once a firm's investment reached at least $2,000,000, the amount eligible is reduced one dollar for each dollar of investment in excess of $2,000,000. Thus once a firm's investment reached $2,500,000, no deduction is allowed. Without extension the exemption will revert to its permanent level of $25,000, with a phase-out beginning at $200,000. No deduction would be allowed when investment is $225,000. Off-the-shelf computer software will also no longer be eligible and a $250,000 expensing provision for leasehold property, which was eligible for expensing in 2014, will no longer be allowed.

The first expensing provision was relatively small when adopted as a permanent provision in the Small Business Tax Revision Act of 1958 (P.L. 85-866). It allowed a deduction of 20% of the first $20,000 ($10,000 for a single return). The provision was first revised in the Economic Recovery Tax Act of 1981 (P.L. 97-34) to allow a deduction for all costs with limits of $10,000. The limits were revised over time, but the limits were small and the changes were permanent.

The temporary increases since 2002 occurred in two distinct parts. The first increase occurred when the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) increased the maximum allowance to $100,000, and the beginning of the phase-out to $400,000, effective from 2003-2005. This bill also added the off-the-shelf software to eligible property. The U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Appropriations Act of 2007 (P.L. 110-28), increased the limit to $125,000, and the phase-out point to $500,000, through 2010. All of the so-called Bush tax cuts were due to expire at the end of 2010, but they were extended near the end of December that year.

The second set of temporary increases was part of the stimulus bills to address the 2007-2009 recession. The Economic Stimulus Act of 2008 (P.L. 110-185) increased the limit to $250,000 and the phase-out point to $800,000; this provision was extended by subsequent legislation through 2010. In the Small Business Jobs Act of 2010 (P.L. 111-240) the limit was increased to $500,000 with a phase-out at $2,000,000, through 2011, and the leasehold property provision was added. These provisions were subsequently extended.

Because one set of extensions might be considered part of the Bush-era tax cuts, which might be made permanent along with other provisions, while another part is associated with a temporary stimulus along with the option to extend all of the limits, one option might be to extend or make the Bush-era tax provisions permanent and allow the higher limits added in 2008 and 2010 to expire.

The original expensing provision in 1958 was justified as a simplification of depreciation rules for small firms and a way to provide them an incentive to invest more. This argument is more difficult to make with the higher spending caps from recent years. Later expansions, as in the case of bonus depreciation, were justified to stimulate investment.

---

[22] IRC Section 179.

Extending the temporary provisions of Section 179 is likely to be relatively ineffective as a stimulus. It has no incentive effect after the maximum cap is reached, and it increases the cost of capital in the phaseout range. As noted earlier, bonus depreciation, which had no limits or phase-outs, did not appear to be an effective stimulus.

For more information, see *Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 114th Congress, and Economic Effects*, by Gary Guenther.

## Special Expensing Rules for Certain Film and Television Productions[23]

Investments in film and television productions are generally recovered using the income forecast method. Under this method, depreciation deductions are based on the pattern of expected earnings.

The American Jobs Creation Act of 2004 (P.L. 108-357) included special rules to allow expensing for certain film and television production costs. The main purpose of the provision was to discourage "runaway" productions, or the production of films and television shows in other countries, where tax and other incentives are often offered. Initially, the provision was set to expire at the end of 2008. However, since 2008, the provision has regularly been extended as part of "tax extender" packages.

Under the special expensing rules for film and television production, taxpayers may elect to deduct immediately up to $15 million of production costs ($20 million for productions produced in certain low-income and distressed communities) in the tax year incurred. Eligible productions are limited to those in which at least 75% of the compensation paid is for services performed in the United States. For productions that started before 2008, the expensing deduction is not allowed if the aggregate production cost exceeds $15 million ($20 million for productions in designated low-income and distressed communities).

The ability to expense (deduct immediately) certain film and television production costs provides a benefit by allowing deductions to be taken earlier, thus deferring tax liability. The magnitude of the benefit depends on the average lag time from production to earning income. For many films, production costs would be deductible in the year the film is released. If the film is released one year after the production costs are incurred, which may be the case for independent and smaller productions, the provision accelerates cost recovery by one year. The benefit conferred by accelerating cost recovery deductions by one year is limited. Furthermore, taxpayers with limited or no tax liability may derive little or no benefit from the expensing allowance.

The primary policy objective of providing special tax incentives for film and television producers is to deter productions from moving overseas, lured by lower production costs as well as tax and other subsidies offered by foreign governments. In evaluating this incentive, one consideration is the economic value of domestic film and television production relative to the cost of the targeted tax benefits.

[23] IRC Section 181(f).

## 15-Year Straight Line Depreciation Provisions[24]

Three types of non-residential structure investments that would otherwise be depreciated over 39 years could be depreciated over 15 years under this provision. These categories include certain leasehold improvements (improvements that are made pursuant to leasing use to a tenant), restaurant property, and retail improvements. Qualified leasehold improvements are those done pursuant to a lease at least three years after a building is constructed. They cannot involve any enlargement of the building, elevator, escalator, structural components benefitting a common area, or the internal framework of the building. Restaurant property improvements can qualify for a new or existing building as long as more than 50% of the space is devoted to the preparation and serving of meals. Retail property improvements must be made at least three years after the building was constructed and apply to the sale of goods, not services.

Leasehold improvements were also eligible for bonus depreciation and a Section 179 deduction up to $250,000 (see discussions above) in 2014.

The leasehold improvement and restaurant provisions were originally enacted in the American Jobs Creation Act of 2004 (P.L. 108-357). Under this act, investments made after October 22, 2004, through 2007 were eligible for the 15-year depreciation. At that time both leasehold and restaurant improvements had to have been undertaken at least three years after the building was constructed. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (P.L. 110-343) extended these provisions through 2009, eliminated the three-year rule for restaurant property, and added the retail provision. It excluded all but leasehold improvements from bonus depreciation.

The main argument against these provisions is that buildings, since 1981, have been depreciated as a composite investment with the aim of averaging out the treatment of different components to reflect the overall value of depreciation. Prior to this change, taxpayers were engaging in component depreciation, separating out various short-lived components (such as a roof) for shorter lives. Under the current composite treatment, if a taxpayer puts a roof on a building that roof is depreciated on the standard useful life, because the overall life allows for the slower depreciation of some components and the quicker depreciation of others (such as the building shell). Component depreciation, where different parts of the building were depreciated separately, was eliminated in the Economic Recovery Tax Act of 1981. By allowing the separation of specific components for shorter lives without increasing them for longer-lived components, this provision undermines composite depreciation.

The argument for faster depreciation for leasehold improvements is that these are made based on the preferences of the leaseholder and may become obsolete with another leaseholder. The argument for retail and restaurant property is that they actually depreciate faster than other buildings, although this is not the position taken by the Bureau of Economic Analysis in their estimates of economic depreciation.[25]

[24] IRC Sections 168(e)(3)(E)(iv), (v), (ix).

[25] Depreciation rates are at http://www.bea.gov/national/pdf/BEA_depreciation_rates.pdf. Commercial buildings have depreciation rates that are slower than industrial buildings.

## Seven-Year Recovery Period for Motorsports Entertainment Complexes[26]

An exception from the 39 year depreciation life for nonresidential structures exists for the theme and amusement park industry. Assets in this industry are assigned a recovery period of seven years. Historically, motorsports racing facilities have been included in this industry and also allowed a seven-year recovery period. However, ambiguities in the law led to questions about whether motorsports racing facilities were correctly categorized. When the Treasury reconsidered the appropriateness of this classification in 2004, Congress made the seven-year treatment mandatory through 2007 with the American Jobs Creation Act of 2004 (P.L. 108-357). Since 2004, the provision has been extended as part of "tax extenders" legislation. Without this provision, motorsports racing facilities would be depreciated over the standard 39-year life.

The tax authorities presumably estimated motorsports racing facilities to have slower depreciation rates than the seven-year life that applies to amusement park facilities. If so, this provision constitutes a subsidy to the auto racing industry that does not appear to have an obvious justification. Supporters argued that the provision preserves historical treatment and provides a stimulus to business. They also argued that the benefit helps make them more competitive with sports facilities that are often subsidized by state and local governments.

## Three-Year Depreciation for Race Horses Two Years or Younger[27]

The cost recovery period for horses is seven-years, although race horses that begin training after age two have a three-year recovery period. Under the temporary provision, this three-year recovery period is extended to all race horses. In particular, all race horses placed in service after December 31, 2008, and before January 1, 2015, have a three-year recovery period as a result of the Food, Conservation, and Energy Act of 2008 (P.L. 110-246).[28] The industry claims that reducing the recovery period to three years more closely aligns the recovery period with the racing life of a horse. The IRS cost recovery period suggests a longer view. Some race horses continue in productive activity after their racing career through breeding, as well has having a residual value for resale. A Treasury study estimated, taking those uses into account, an overall economic life of nine years.[29]

This provision does not affect breeders who race their own horses, since they deduct the cost of breeding and thus have no basis in the horses. The provision generally benefits investors who purchase horses.

[26] IRC Sections 168(i)(15) and 168(e)(3)(C)(ii).

[27] IRC Section 168(e)(3)(A).

[28] This provision expired for the first time at the end of 2013. Thus, the provision has not previously been extended.

[29] U.S. Department of the Treasury, Report to Congress on the Depreciation of Horses, March 1990, http://www.treasury.gov/resource-center/tax-policy/Documents/depreci8study_horses.pdf.

## Accelerated Depreciation for Business Property on an Indian Reservation[30]

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) contained a provision allowing businesses on Indian reservations to be eligible for accelerated depreciation (through a reduction in the applicable recovery periods), as part of an effort to increase investment in Indian Reservations. Since its initial temporary enactment, this provision has regularly been extended as part of "tax extenders" legislation.

Extending the provision might encourage additional investment on Indian Reservations. However, if the main target of these provisions is an improvement in the economic status of individuals currently living on Indian Reservations, it is not clear to what extent this tax subsidy will succeed in that objective, as these subsidies are not given directly to workers but instead are received by businesses. Capital subsidies may not ultimately benefit workers. It is possible that capital equipment subsidies may encourage more capital intensive businesses and make workers relatively worse off. In addition, workers would not benefit from higher wages resulting from an employer subsidy if the wage is determined by regulation (the minimum wage) that is set higher than the prevailing market wage.

# Regulated Investment Company Provisions

A regulated investment company (RIC) is an entity that meets the following conditions: (1) its income is generally earned from passive investments; (2) it distributes at least 90% of its income; and (3) it elects to be taxed as an RIC. Mutual funds are examples of RICs.

## Treatment of Certain Dividends of Regulated Investment Companies (RICs)[31]

A key feature of the RIC tax regime is the ability to deduct income distributed to its shareholders as dividends—effectively passing the tax forward to its shareholders who generally treat this income as ordinary income. However, certain dividends are subject to a gross-basis tax and withholding, with an exception.

The American Jobs Creation Act of 2004 (P.L. 108-357) contained a provision that exempts interest-related and short-term capital gains dividends from the U.S. income tax (and withholding) if they are paid to a foreign person and the income wouldn't have been subject to the tax if it had been earned directly by a foreign person. The provision has subsequently been extended and modified multiple times.

The provision was enacted as part of a broader effort to reform and simplify the tax code for businesses. The provision mitigates a disparity between the tax treatment of direct and indirect investment of foreign persons.

[30] IRC Section 168(j)(8).

[31] IRC Sections 871(k)(1)(C) and (2)(C), and 881(e)(1)(A) and (2).

## RIC Qualified Investment Entity Treatment under FIRPTA[32]

In general, a foreign person or corporation is not taxed on U.S. source capital gains income unless certain conditions are met. However, if the income is from selling U.S. real property, the distribution is taxed at the same rates as a U.S. person under the Foreign Investment in Real Property Tax Act (FIRPTA). The FIRPTA rules, adopted in 1980, considered investment in real property to be income effectively connected to business which is generally subject to U.S. taxes. There is an exception if (1) the investment is made through a qualified investment entity; (2) the U.S. real property is regularly traded on an established U.S. securities market; and (3) the recipient foreign person or corporation did not hold more than 5% of that class of stock or beneficial interest within the one-year period ending on the date of distribution. The temporary exception was enacted in the American Jobs Creation Act of 2004 (P.L. 108-357) and has since been extended several times as part of various "tax extenders" legislation.

Most passive income of foreigners is generally not taxed by the United States because of exceptions in law or tax treaties, just as most passive income earned by U.S. citizens abroad is not taxed by foreign governments. Thus, the provision mitigates a disparity between the tax treatment of direct and indirect investment of foreign persons. The provision encourages investment in real property in the United States through eligible entities.

# Other Provisions

## Tax Credit for Research and Experimentation Expenses[33]

The research and experimentation credit (or the research credit) is 20% of the amount by which qualified research expenses exceed a base amount, with a minimum of 50% of current research expenses. The base amount is a past fixed amount of spending that increases over time with the increase in gross receipts. There is also an alternative credit of 14% for research in excess of 50% of the average qualified research over the past three years. Because this alternative credit has a base that increases with research expenditures of the firm, an additional dollar of spending in year one increases the base for future spending, which reduces the incentive to an estimated 7.9%.[34] The incentive in the regular credit is also reduced from 20% to 10% through this mechanism if the credit's base is limited by the 50% of total spending minimum. The credit also has a basis adjustment so that credit amounts cannot also be deducted. For a corporation expensing these costs and at the top tax rate, the credit is reduced by 35%, so the effective credit rate is 13% (6.5% if the 50% minimum rule applies, and 5.1% if the alternative credit is used).

There are two additional credits: 20% (in excess of a base) for university basic research that is not directed at commercial objectives and 20% (without a base) for contract energy research.

[32] IRC Section 897(h)(4).

[33] IRC Section 41(h)(1)(B).

[34] An additional dollar today causes the base to increase in the future. For example, in the following year the base will be higher by $1, multiplied by 0.5, divided by 3 and divided by (1+r) where r is the discount rate. The current expenditure will also increase the base in the same way in the second year out (except that the discount factor is $(1+r)^2$) and in the third year out (with a discount factor of $(1+r)^3$). Using a discount rate of 7%, the value will fall from 14% to 7.9%.

Qualified research expenditures must be experimental, for the purpose of discovering information that is technological in nature and used in the development of a new or improved product, process, computer software technique, formula or invention that is to be leased, licensed, or used by the firm. These expenses include wages and salaries of researchers, supplies, costs of using computers, and from 65% to 100% of contract research. Equipment and structures are not eligible. Research must be conducted in the United States.

The original research credit was adopted in the Economic Recovery Act of 1981 (P.L. 97-34), at a 25% rate and without a basis adjustment. It was in excess of a base equal to the average of the past three years of research spending. As in the case of the current alternative credit, an additional dollar increased the base in the future but had a more powerful effect, reducing the effective credit to about 3%.

The credit has been extended numerous times, lapsed for one year, and has been extended retroactively. It was also revised in a variety of ways, some of which remain and some which were overtaken by other changes. Among significant changes the Tax Reform Act of 1986 (P.L. 99-514) reduced the rate to 25%. The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) added a partial (half) basis adjustment. A major change was made in the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239), which created a three-year fixed base for the credit that was then adjusted by the growth in gross receipts, significantly increasing the effective credit. That legislation also added the full basis adjustment. A different alternative credit was added in the Small Business Job Protection Act of 1996 (P.L. 104-188), but the current form of the alternative credit was added in Tax Relief and Health Care Act of 2006 (P.L. 109-432), so that for a time there were two alternatives. The earlier alternative credit was repealed in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312).

Many economists agree that there is an economic justification for subsidizing research and development (R&D) because private firms are not able to capture the full return from an innovation, so that the total amount they invest is likely to fall short of the level of investment warranted by the social returns. This outcome is called a market failure because value of the benefits is greater than the cost for the last dollars spent and additional spending could yield benefits above the additional costs. Despite patents and secrecy, an innovation may provide information to others that can be exploited. Evidence suggests that the social return (the return to other firms and customers as well as to the original firm) is higher than the private return.

The research credit, however, arguably is a blunt instrument to address this market failure since it does not vary based on the size of the spillover effect. Targeted grants are an alternative method of subsidizing research. Others suggest that some types of research (such as creating computer games) should not be subsidized. Additionally, the uncertainty over whether the credit will be extended likely reduces its effectiveness.

For more information, see CRS Report RL31181, *Research Tax Credit: Current Law and Policy Issues for the 114th Congress*, by Gary Guenther.

## Credit for Certain Expenditures for Maintaining Railroad Tracks[35]

Qualified railroad track maintenance expenditures paid or incurred in a taxable year by eligible taxpayers qualify for a 50% business tax credit. The credit is limited to $3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer. Qualified railroad track maintenance expenditures are amounts, which may be either repairs or capitalized costs, spent to maintain railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III (regional or local) railroad. Eligible taxpayers are smaller (Class II or Class III) railroads and any person who transports property using these rail facilities or furnishes property or services to such a person.

The taxpayer's basis in railroad track is reduced by the amount of the credit allowed (so that any deduction of cost or depreciation is only on the cost net of the credit). The credit cannot be carried back to years before 2005. The credit is allowed against the alternative minimum tax. The amount eligible is the gross expenditures, not taking into account reductions such as discounts or loan forgiveness.

The provision was enacted in the American Jobs Creation Act of 2004 (P.L. 108-357). The provision relating to discounts was added by the Tax Relief and Health Care Act (P.L. 109-432). The credit was allowed against the alternative minimum tax by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

This provision substantially lowers the cost of track maintenance for the qualifying short line (regional and local) railroads, with tax credits covering half the costs for those firms and individuals with sufficient tax liability. Class II and III railroads account for 31% of the nation's rail miles.[36] These regional railroads are particularly important in providing transportation of agricultural products.

While no rationale was provided when the credit was introduced, sponsors of earlier free-standing legislation and industry advocates indicated that the purpose was to encourage the rehabilitation, rather than the abandonment, of short-line railroads. These railroads were spun off in the deregulation of railroads in the early 1980s. Advocates also indicated that this service is threatened by heavier 286,000-pound cars that must be used to connect with longer rail lines. They also suggested that preserving these local lines will reduce local truck traffic. There was also some indication that a tax credit was thought to be more likely to be achieved than grants.

The arguments stated by industry advocates and sponsors of the legislation are also echoed in assessments by the Federal Railroad Administration (FRA), which indicated the need for rehabilitation and improvement, especially to deal with heavier cars. The FRA also suggested that these firms have limited access to bank loans.

In general, special subsidies to industries and activities tend to lead to inefficient investment allocation, since in a competitive economy businesses should earn enough to maintain their capital. Nevertheless it may be judged or considered desirable to subsidize rail transportation to reduce the congestion and pollution of highway traffic. At the same time, a tax credit may be less

[35] IRC Section 45G(f).

[36] *Railroad Facts* American Association of Railroads, 2012.

suited to remedy the problem than a direct grant since firms without sufficient tax liability cannot use the credit.

## Reduction in S-Corporation Recognition Period for Built-In Gains[37]

Closely held corporations (100 or fewer shareholders) can elect to be taxed as S corporations, where income flows through to the individual owners as is the case with a partnership. Firms that first operate as a corporation (a C corporation), and switch to an S corporation, are taxed separately at the top corporate rate of 35% on gain that is attributable to the years when the corporation was a C corporation. This treatment applies for the first 10 years the firm is an S corporation. An individual income tax also applies to the gain, net of the corporate level tax. The extender provision reduces that period to five years.

If a C corporation converts to a partnership or other non-corporate entity, the conversion triggers both a corporate-level and an individual-level tax on gains. Without the built-in gains requirement, C corporations converting to S corporations (where a taxable event is not triggered) could sell assets after conversion with a single level of tax on gains at a relatively low rate. This provision requires gains recognized over a period of years that are gains from the C corporation period to be taxed at a higher rate.

The 10-year period was reduced to seven years by the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5). It was further reduced to five years by The Small Business Jobs Act of 2010 (P.L. 111-240).

The reduction to five years allows more gains to avoid this tax. It also increases the incentive to convert to S corporation status rather than partnership form. S corporations are limited to 100 shareholders. Therefore, this benefit accrues to businesses that are likely to be closely held. No specific rationale has been given for including this provision in a stimulus bill (ARRA).

## Election to Accelerate AMT Credits in Lieu of Additional First-Year Depreciation[38]

Firms are potentially subject to an alternative minimum tax (AMT) applied to a broader base, but with a lower rate for large corporations and high income business owners. Since the higher AMT tax may arise from timing shifts (because of the longer depreciation period under the AMT base) a credit is allowed for the excess of the AMT over regular tax if the regular tax exceeds the AMT tax in future years, up to the amount of the excess regular tax.

Under the provision, firms may elect to forgo bonus depreciation as well as regular accelerated depreciation for purposes of calculating both AMT and regular income tax liability. In turn, firms can increase the amount of AMT credits by 20% of bonus depreciation. These credits are refundable, but are limited to the lesser of $30 million, or 6% of credit forwards generated before January 1, 2006, whichever is smaller.

[37] IRC Section 1374(d)(7).

[38] IRC Section 168(k).

This election can provide firms that would not use bonus depreciation because of lack of tax liability some tax reductions.

This provision was first enacted for both research and experimentation credits and AMT credits in the Housing and Economic Recovery Act of 2008 (P.L. 110-289), shortly after bonus depreciation was enacted in mid-2008. It was subsequently extended, but the extension in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) limited the provision to the AMT credit. It continued to be extended through 2014.

This provision was part of the stimulus proposals enacted to combat the 2007-2009 recession. The provision does not directly affect marginal investment, but it does affect cash flow. Most forecasters believe this type of cash flow benefit has to have a minimal effect on economic stimulus.[39] For firms that are in distress, however, cash flow may be more likely to contribute to spending.

## Temporary Increase in Limit on Cover Over of Rum Excise Tax Revenues to Puerto Rico and the Virgin Islands[40]

Most federal excise taxes do not apply in the United States Virgin Islands (USVI) and Puerto Rico (PR) or the other possessions. An exception, however, is a special excise tax on items produced in PR or the USVI and shipped to the United States. The tax was first imposed to ensure that producers in the possessions would not have a tax advantage over producers in the United States that are subject to excise taxes. In the case of rum that is produced in either the USVI or PR and sold in the United States, most of the revenue from the so-called equalization tax is returned ("covered over") by the federal government to the treasuries of PR and the USVI.

The cover-over provisions for rum extend as far back as 1917 for PR and 1954 for the USVI. The scope of the cover-over was expanded by the Caribbean Basin Economic Recovery Act of 1983 (P.L. 98-67) which provides that all revenue from federal excise taxes on rum imported into the United States from any source—including any foreign country—is remitted to the treasuries of PR and the USVI by a formula that is roughly based upon the shares of rum produced by the two possessions. The Deficit Reduction Act of 1984 (P.L. 98-369) placed a cap on the rebate of excise taxes on rum and other distilled spirits based upon a $10.50 rate even as the federal tax rate on spirits rose to $12.50 and later $13.50 per proof-gallon. Subsequently, temporary increases in this limit have routinely been enacted.

The justification for the return of the revenues was to provide for the welfare of the territories and return revenue generated from their products, since the territories could not participate in federal provisions benefitting the states. Controversy about the provision arose from the use of funds in the USVI to subsidize rum producers, which then led to increased subsidies by PR, which had previously had a limit on the share of the cover-over that could subsidize the rum industry. From the federal government's perspective, state and local incentives for industrial development are a

[39] For recent estimates of output multipliers associated with tax provisions affecting cash flow, see Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from January 2012 Through March 2012*, May 2012, available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/ARRA_One-Col.pdf.

[40] IRC Section 7652(f).

redistribution of tax dollars from state and local governments to manufacturing firms without a net gain in national GDP. From this perspective, the incentives shift economic activity from one location in the United States to another. The intended improvement of social welfare (i.e., helping economically disadvantaged areas) is usually the justification for such policies in light of what many economists identify as the "zero-sum" nature of the incentives.

The recent recession and related budget situation have elevated the interest in the rum cover-over program. From the perspective of U.S. taxpayers, some may question the efficacy of the rum cover-over, regardless of the historical precedent. Further, proponents of restrictions on the use of covered-over revenue have alluded to the possibility that Congress may reconsider the cover-over principle generally, possibly ending the program, if the recipients use the revenue for "unreasonable" subsidies.

For more information, see CRS Report R41028, *The Rum Excise Tax Cover-Over: Legislative History and Current Issues*, by Steven Maguire.

## 100% Exclusion for Qualified Small Business Stock[41]

Under current law, gains on the sale of capital assets held longer than one year generally are taxed at rates lower than the rates for ordinary income. Individual taxpayers in the 10% and 15% tax brackets pay no tax on long-term capital gains, whereas long-term gains reported by most taxpayers in higher brackets are taxed at a fixed rate of 15%. For taxpayers in the 39.6% tax bracket, capital gains are taxed at a fixed rate of 20%.

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) contained a provision that allowed an exclusion from gross income of 50% of any gain from the sale or exchange of qualified small business stock (QSBS) issued after August 10, 1993. This provision is permanent. In the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), an exclusion of 75% was allowed. The Small Business Jobs Act of 2010 (P.L. 111-240) increased the exclusion to 100%. Subsequent extensions and modifications of the provision allow for a full exclusion of any gain for stock acquired after September 27, 2010, and before January 1, 2015.

To be eligible, the taxpayer must acquire the stock at its original issue and hold it for a minimum of five years. There is an annual limit on the exclusion for gains on the sale of QSBS issued by the same firm: the exclusion cannot exceed the greater of $10 million, less any cumulative gain excluded by the taxpayer in previous tax years, or ten times a taxpayer's adjusted basis in the stock.

The original provision was adopted when capital gains were taxed as ordinary income. Part of the reason for adopting the increased exclusion was that the benefit was lessened or disappeared with the lower tax rates on capital gains.

The special benefit for this small business stock appears to have been intended to facilitate the formation and growth of small firms organized as C corporations involved in developing new manufacturing technologies. The provision provides investors an incentive to acquire a sizable equity stake in small firms.

[41] IRC Section 1202(a)(4).

An exclusion of part (or all) of the gain from small business stock allows for investors in firms of different sizes to face different effective tax rates. Along with the effect on equity, the provision may also reduce economic efficiency through its distortionary effect on the allocation of capital. The provision could, however, increase economic efficiency if it were to correct for capital market imperfections and allow for optimal small business formation and growth.

## Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico[42]

The Section 199 domestic production activities deduction reduces tax rates on certain types of economic activity, primarily domestic manufacturing activities. Qualified domestic manufacturing activities qualify for a deduction equal to 9% of the lesser of taxable income derived from qualified production activities or taxable income. The effect of the deduction is to reduce the effective tax rate on income from qualified activities by 3.15 percentage points, from 35% to 31.85%. The Section 199 domestic production activities deduction is a permanent part of the Internal Revenue Code (IRC).

When the Section 199 deduction was enacted as part of the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357), the term "United States," as used for the purposes of determining eligible domestic activities, included the 50 states and the District of Columbia, but not U.S. possessions or territories. In 2006, as part of the Tax Relief and Healthcare Act (P.L. 109-432), special rules that allowed Puerto Rico to be considered a part of the United States for the purposes of the Section 199 domestic production activities deduction were temporarily enacted. This temporary provision has recently been extended as part of "tax extenders" legislation.

The U.S. tax code generally treats U.S. possessions as foreign countries, and Puerto Rico maintains an independent tax system. There are, however, many special rules interconnecting the Puerto Rican and U.S. tax systems. Before 1996, domestic corporations with business operations in the United States possessions could generally eliminate their U.S. tax liability on foreign-source income from operations in the possessions using the possessions tax credit. From 1996 through 2005, the Puerto Rico economic activity credit was available for domestic corporations with activities in Puerto Rico. Following the expiration of the possessions tax credit and Puerto Rico economic activity credit, companies with operations in Puerto Rico may find it more advantageous to structure as a controlled foreign corporation (CFC), thus benefitting from the option to defer U.S. tax on active income from those operations.

Allowing the Section 199 production activities deduction to be claimed on manufacturing activities in Puerto Rico can be viewed as an effort to provide similar tax treatment to income from manufacturing activities taking place in Puerto Rico and from the rest of the United States.[43] Absent this provision, U.S.-based manufacturers with operations in Puerto Rico, operating in flow-through form (e.g., a branch or partnership), would face a higher effective tax rate on manufacturing activities in Puerto Rico than other domestic manufacturing activities.

[42] IRC Section 199(d)(8).

[43] See U.S. Congress, Joint Committee on Taxation, An Overview Of The Special Tax Rules Related To Puerto Rico And An Analysis Of The Tax And Economic Policy Implications Of Recent Legislative Options, 109th Cong., June 23, 2006, JCX-24-06, available at https://www.jct.gov/publications.html?func=startdown&id=1496.

Allowing the Section 199 deduction for activities in Puerto Rico essentially extends a tax benefit designed for domestic corporations to a possession that is generally treated as a foreign country for tax purposes. This raises the question of why this tax benefit has been provided to Puerto Rico but no other U.S. possessions. Concerns have also been raised that extending Section 199 to Puerto Rico would create an incentive for U.S. companies operating in Puerto Rico to adopt a bifurcated structure, with certain activities being undertaken by a CFC with other activities, specifically those that qualify for Section 199, being undertaken in a flow-through structure.[44] Since other domestic businesses do not have this organizational flexibility, this would provide greater potential benefits to manufacturers with operations in Puerto Rico. This could be the intent of the policy, if extending Section 199 to businesses in Puerto Rico is intended, in part, to encourage additional manufacturing activity in Puerto Rico.

For general information on the Section 199 deduction, see CRS Report R41988, *The Section 199 Production Activities Deduction: Background and Analysis*, by Molly F. Sherlock.

## Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations[45]

Tax-exempt organizations are required to pay taxes on unrelated business taxable income (UBTI), which is defined as income resulting from business activities that are unrelated to their charitable or tax-exempt purpose. Rents, royalties, interest, and annuities (passive income) are generally not considered business taxable income, except when such payments are received from a "controlled entity."[46]

The Pension Protection Act of 2006 (P.L. 109-280) included special rules temporarily providing that certain payments, including rents and royalties received by a tax-exempt entity from a controlled entity or subsidiary, are not considered unrelated business income. Payments that are in excess of an arms-length price cannot be excluded from UBTI. Since being enacted, these rules have regularly been extended as part of "tax extenders" legislation.

The purpose of including payments received from controlled entities in business taxable income is to prevent tax-exempt organizations from using separate but controlled entities to avoid unrelated business income taxes. For example, one concern is that a 501(c)(3) charitable organization could set up a controlled subsidiary to engage in a profitable activity (e.g., selling merchandise). If the charity had sold the merchandise itself, the income would be subject to the unrelated business income tax. To avoid the tax, the charity could set up a controlled subsidiary to sell the merchandise, which would pay royalties to the charity (lease the charity's logo, for example). The controlled subsidiary would deduct the royalty payments as a cost of doing business, and the charity would receive royalty income, which would not be considered unrelated business income. In this scenario, the charity would avoid paying tax on business activities.

Treating rent, royalty, interest, and annuity payments from controlled organizations as UBTI while similar types of payments from third parties are not taxed may raise questions related to fairness. Tax-exempt entities could claim that as long as tax-exempt parents' dealings with

[44] *Ibid.,* pp. 90-93.

[45] IRC Section 512(b)(13)(E).

[46] A controlled entity is one that is more than 50% owned (or otherwise controlled) by the parent organization.

controlled subsidiaries are done at arm's length, the scope for abuse should be limited. It is this logic that led to the enactment of the provision modifying the tax treatment of certain payments to controlling exempt organizations.

## Author Contact Information

Jane G. Gravelle
Senior Specialist in Economic Policy
jgravelle@crs.loc.gov, 7-7829

Donald J. Marples
Specialist in Public Finance
dmarples@crs.loc.gov, 7-3739

Molly F. Sherlock
Coordinator of Division Research and Specialist
msherlock@crs.loc.gov, 7-7797