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DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2012 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are included in the President's fiscal year 2012 budget proposal, as submitted to the Congress on February 14, 2011.[2] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget proposals.[3] For each provision, there is a description of present law and the proposal (including effective date), an analysis of policy issues related to the proposal, and a reference to relevant prior budget proposals or recent legislative action.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-2011), June 2011.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2012: Analytical Perspectives* (H. Doc. 112-3, Vol. III), pp. 197-219.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011.

PART I − TAX CUTS FOR FAMILIES AND INDIVIDUALS

A. Provide $250 Economic Recovery Payment and Special Tax Credit

Present Law

American Recovery and Reinvestment Act of 2009

Economic recovery payments

In general, ARRA provided a one-time economic recovery payment of $250 in 2009 to adults eligible for Social Security benefits, Railroad Retirement benefits, veteran's compensation or pension benefits or to individuals eligible for Supplemental Security Income (SSI) benefits (excluding individuals who receive SSI while in a Medicaid institution).

Economic recovery payments were made to individuals whose address of record was in one of the 50 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa, or the Northern Mariana Islands. If an individual who was eligible for an economic recovery payment had a representative payee, the payment was made to the representative payee and the entire payment was required to be used for the benefit of the individual who was entitled to the economic recovery payment.

Under ARRA, an individual was eligible for only one $250 economic recovery payment regardless of whether the individual was eligible for a benefit from more than one of the four Federal programs. If the individual was also eligible for the making work pay credit in 2009 that credit was reduced by the economic recovery payment.

Individuals who were otherwise eligible for an economic recovery payment did not receive a payment if their Federal program benefits had been suspended because they were in prison, a fugitive, on probation or a parole violator, had committed fraud, or were no longer lawfully present in the United States.

Economic recovery payments are not to be taken into account as income, or taken into account as resources for the month of receipt and the following nine months, for purposes of determining the 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.

Economic recovery payments are not includible in gross income for income tax purposes and the payments are protected from the assignment and garnishment provisions of the four federal benefit programs. The payments are subject to the Treasury Offset Program.

Special credit for certain government retirees

ARRA created a $250 refundable credit ($500 for a joint return where both spouses are eligible) against income taxes owed for tax year 2009 for individuals who receive a government pension or annuity from work not covered by Social Security, and who are not eligible to receive an economic recovery payment. If the individual is also eligible for the making work pay credit,

that credit is reduced by the special ARRA credit. Each tax return on which the credit is claimed is required to include the social security number of the taxpayer (in the case of a joint return, the social security number of at least one spouse).

The ARRA special credit or refund is not taken into account as income, or taken into account as resources for the month of receipt and the following two months for purposes of determining the 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

Under the proposal, a $250 refundable income tax credit ($500 for a joint return where both spouses are eligible) for 2011 is allowed for individuals who receive a government pension or annuity from work not covered by Social Security, and who are not eligible to receive an economic recovery payment.[4]

Effective date.−The proposal is effective on the date of enactment.

Analysis

The Administration believes that providing these benefits to retirees is necessary to help stimulate consumption in order to assure that the present economic recovery does not falter. The Administration further believes that assistance provided under these two proposals helps ensure equal treatment between retirees under these proposals and non-retirees receiving the temporary payroll tax reduction (employee side of OASDI) by two percentage points.

Some might argue against these two proposals on the grounds that the Federal government's fiscal position is sufficiently perilous that adding to the deficit at this time may not provide the hoped-for stimulus if investors retrench on fears concerning the level of U.S. debt. Others may additionally object that these payments are not well targeted. Many retirees are in a better position economically than young families, and the payment and credit are not restricted based on income.

Prior Action

A similar provision was included in the President's fiscal year 2011 budget proposal.

[4] Under another administration proposal, a one-time economic recovery payment of $250 for 2011 ($500 for a joint return where both spouses are eligible) is provided to adults who are eligible for Social Security benefits, Railroad Retirement benefits, or veteran's compensation or pension benefits; or individuals who are eligible for SSI benefits (excluding individuals who receive SSI while in a Medicaid institution).

B. Increase in the Earned Income Tax Credit

Present Law

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EITC 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 EITC generally equals a specified percentage of earned income[5] 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 adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC 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 EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,150 (for 2011). 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 EITC 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 EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC 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 EITC), 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,

[5] For purposes of the EITC, earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes.

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.[6]

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 $6,070, resulting in a maximum credit of $464 for 2011. The maximum is available for those with incomes between $6,070 and $7,590 ($12,670 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above $7,590 ($12,670 if married filing jointly) resulting in a $0 credit at $13,660 of earnings ($18,740 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2011 of 34 percent of their earnings up to $9,100, resulting in a maximum credit of $3,094. The maximum credit is available for those with earnings between $9,100 and $16,690 ($21,770 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings above $16,690 ($21,770 if married filing jointly). The credit is completely phased out at $36,052 of earnings ($41,132 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2011 of 40 percent of earnings up to $12,780, resulting in a maximum credit of $5,112. The maximum credit is available for those with earnings between $12,780 and $16,690 ($21,770 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $16,690 ($21,770 if married filing jointly). The credit is completely phased out at $40,964 of earnings ($46,044 if married filing jointly).

A temporary provision enacted by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[7] allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2011 and 2012. For example, in 2011 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $12,780, resulting in a maximum credit of $5,751. The maximum credit is available for those with earnings between $12,780 and $16,690 ($21,770 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $16,690 ($21,770 if married filing jointly). The credit is completely phased out at $43,998 of earnings ($49,078 if married filing jointly).

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[6] All income thresholds are indexed for inflation annually.

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

Under a provision of the American Recovery and Reinvestment Act of 2009[8], the phase-out thresholds for married couples were raised to an amount $5,000 above that for other filers for 2009 (and indexed for inflation). The increase is $5,080 for 2011.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

Description of Proposal[9]

The proposal permanently extends the EITC at a rate of 45 percent for three or more qualifying children.

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

Proponents argue that the EITC is generally structured to provide greater tax benefits to families with more children, and thus they believe it is appropriate to extend the additional benefits that were recently made available on a temporary basis to larger families with three or more children.

Some opponents may argue that the expansion of the earned income tax credit to individuals who some may not consider low- or moderate-income taxpayers (since eligibility for the credit can extend past $48,000[10] of income) is inappropriate.

Prior Action

A similar provision was included in the President's fiscal year 2010 and 2011 budget proposals.

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[8] Pub. L. No. 111-5.

[9] See also Part XIII.F, Marriage Penalty Relief and Earned Income Tax Credit Simplification.

[10] Median family income in the United States in 2008 was $61,521. See U.S. Census Bureau, Historical Income Tables - Families, Table F-6, available at http://www.census.gov/hhes/www/income/histinc/incfamdet.html.

C. Expand the Child and Dependent Care Tax Credit

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 adjusted gross income 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.

After 2012, the maximum credit will fall, and other parameters of the child and dependent care credit will change, as a result of the sunset provisions of EGTRRA.[11]

Description of Proposal

Under the proposal, the AGI level at which the credit rate begins to phase down is increased from $15,000 to $75,000. Thus, the credit rate is decreased by one percentage point for every $2,000 (or part thereof) of AGI over $75,000 until the percentage reaches 20 percent (at incomes above $103,000). As under current law, there are no further income limits and the phase-out point and the amount of expenses eligible for the credit is not indexed for inflation.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

By increasing the income levels at which the credit rate begins to phase down, the proposal increases the effective credit rate for eligible child and dependent care expenses by up to 15 percentage points (yielding a $900 maximum credit increase) for a substantial number of taxpayers. As a result, the proposal reduces the tax burden for workers with employment-related

[11] A separate budget proposal, described in Part XIII.H of this document, provides for the removal of the EGTRRA sunset.

child care expenses. Additionally, by increasing the after-tax return to employment for non-working individuals with child care responsibilities, the proposal could encourage these individuals to seek work outside of the home.

All taxpayers with qualifying expenses and AGI between $15,000 and $103,000 would experience an increase in their credit rate, but to varying degrees. Taxpayers with AGI between $43,000 and $75,000 would experience a rise in their credit rate from 20 percent to 35 percent. Taxpayers formerly in the phasedown range (those with AGI between $15,000 and $43,000), who thus had credit rates between 20 percent and 35 percent, would have their credit rate increased to 35 percent. Taxpayers in the new phasedown range (those with AGI between $75,000 and $103,000) would have credit rates between 20 percent and 35 percent, up from 20 percent previously. Taxpayers experiencing the full increase in the credit rate would experience an increase in their potential credit of $450 (from 20 percent of $3,000 to 35 percent of $3,000) for one qualifying child or $900 for two or more qualifying children (from 20 percent of $6,000 to 35 percent of $6,000). Because the credit is not refundable, taxpayers who have already reduced their regular tax liability to zero with the existing credit structure would not benefit from the increased rate of the credit.

The proposal represents a substantial expansion of the child and dependent tax credit, and if such significant changes to the credit are contemplated by Congress, consideration could be given to other or additional alterations to the credit. For example, an increase in the cap on qualifying expenses would assist those with greater child care expenses, such as those who work full time and/or live in high cost areas. Raising the cap could occur in addition to the contemplated changes to the credit rate or in lieu of them. For the same budgetary cost as the proposal, the caps could be raised with some paring back of the proposed increases to the credit rate. Consideration could also be given to making the credit refundable and to indexing the cap on qualifying expenses and the AGI threshold for the phasedown of the credit rate. Lastly, as the credit is designed to help offset certain costs of earning income, consideration could be given to whether a deduction is the more appropriate tax treatment for an employment-related expense when the tax rate structure is progressive.

Prior Action

A similar provision was included in the President's fiscal year 2011 budget proposal.

D. Automatic Enrollment in Individual Retirement Arrangements

Present Law

Contribution limits

In general

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[12] to which both deductible and nondeductible contributions may be made,[13] and Roth IRAs, to which only nondeductible contributions may be made.[14] 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 earning on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable 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 IRAs) for a taxable year is the lesser of a certain dollar amount ($5,000 for 2011)[15] 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.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. Thus, for example, if an individual over age 50 contributes $6,000 to a Roth IRA for 2011 ($5,000 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers

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[12] Sec. 408.

[13] Sec. 219.

[14] Sec. 408A.

[15] The dollar limit is indexed for inflation.

with AGI for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2011 are: (1) for single taxpayers, $56,000 to $66,000; (2) for married taxpayers filing joint returns, $90,000 to $110,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2011 between $169,000 and $179,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as 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.

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 2011 are: (1) for single taxpayers, $107,000 to $122,000; (2) for married taxpayers filing joint returns, $169,000 to $179,000; 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.

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.

Taxpayers generally may convert a traditional IRA into a Roth IRA.[16] The amount converted is includible in the taxpayer's income as if a withdrawal had been made,[17] except that the early distribution tax (discussed below) does not apply. However, the early distribution tax is recouped if the taxpayer withdraws the amount within five years of the conversion.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date

[16] For taxable years beginning prior to January 1, 2010, taxpayers with modified AGI in excess of $100,000 and married taxpayers filing separate returns were generally not permitted to convert a traditional IRA into a Roth IRA. Under the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, these limits on conversion are repealed for taxable years beginning after December 31, 2009.

[17] A special rule is provided in the case of a rollover in 2010. In such case, unless the taxpayer elects otherwise, the amount includible in income as a result of the conversion is included in income ratably in 2011 and 2012.

for the individual's income tax return for that year.[18] In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). 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. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.[19]

Excise tax on excess contributions

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.[20] This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.[21] To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

Taxation of distributions from IRAs

Traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis in the contract in the form of nondeductible contributions or rolled over, after-tax employee contributions. All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

Roth IRAs

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 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of

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[18] Sec. 408A(d)(6).

[19] Treas. Reg. sec. 1.408A-6.

[20] Sec. 4973(b) and (f).

[21] Sec. 408(d)(4).

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

Early distribution tax

Early withdrawals from an IRA generally are subject to an additional tax.[22] This additional tax applies to distributions from both traditional and Roth IRAs. The tax is calculated by reference to the amount of the distribution that is includable in AGI.[23] Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent tax unless another exception applies. Other exceptions include exceptions for withdrawals: due to death or disability; made in the form of certain periodic payments; used to pay medical expenses in excess of 7.5 percent of AGI; used to purchase health insurance for certain unemployed individuals; used for higher education expenses; used for first-time homebuyer expenses of up to $10,000; or made to a member of a reserve unit called to active duty for 180 days or longer.

Deemed IRAs

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan. This option is available to tax qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA.[24] Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.[25]

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[22] Sec. 72(t).

[23] Because distributions from Roth IRAs attributable to contributions (including conversion contributions) are not includible in gross income and distributions from all Roth IRAs are treated as first attributable to contributions, the early-distribution tax generally will only apply to a distribution from a Roth IRA when only amounts attributable to earnings remain in all Roth IRAs. However, as noted earlier, a special rule applies for withdrawals within five years of a conversion.

[24] Sec. 408(q).

[25] Treas. Reg. sec. 1.408(q)-1.

Payroll deduction IRA

Under current law, an employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997, Congress indicated that "employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs."[26] Congress encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs."[27] In response to that directive, the IRS published Announcement 99-2,[28] which reminds employers of the availability of this option for their employees.

In 1975, the Department of Labor ("DOL") issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to the Employee Retirement Income Security Act ("ERISA").[29] Interpretive Bulletin 99-1[30] restated and updated the DOL's positions on these programs. Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.[31]

Employer retirement plans using IRAs

SIMPLE IRA plan

Under present law, a small business that employs fewer 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 the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE retirement plan is generally a plan under which contributions are made to an

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

[27] H. Rep. No. 102-220, p. 775 (1997).

[28] 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

[29] Labor Reg. sec. 2510.3-2(d).

[30] 64 F.R. 32999, June 18, 1999; Labor Reg. sec. 2509.99-1.

[31] Labor Reg. sec. 2509.99-1.

individual retirement arrangement for each employee (a "SIMPLE IRA").[32] A SIMPLE retirement plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of $11,500 (for 2011). 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 2011).

In the case of a SIMPLE retirement plan, the group of eligible employees generally must include any 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. A SIMPLE retirement plan is not subject to the nondiscrimination rules generally applicable to tax qualified retirement plans.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation); however, a lower percentage cannot be elected for more than two years out of any five year period.[33] 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 with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE retirement plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.[34]

No contributions other than employee elective contributions, required employer matching contributions, or employer nonelective contributions can be made to a SIMPLE retirement plan, and the employer may not maintain any other qualified retirement plan.

Simplified employee pensions

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to tax qualified defined contribution plans ($49,000 for 2011). 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

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[32] There is also an option to provide a SIMPLE plan as part of a section 401(k) plan (a "SIMPLE section 401(k)" plan). In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans under section 410(b). A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

[33] This option is not available for SIMPLE section 401(k) plans.

[34] IRS Notice 98-4, 1998-1 C.B. 269.

at least three of the immediately preceding five years, and (3) received at least $550 (for 2011) 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. The SARSEP rules were generally repealed with the adoption of SIMPLE retirement plans. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($16,500 for 2011). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $5,500 (for 2011).

Automatic enrollment

Under a section 401(k) plan, employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as "elective deferrals" or "elective contributions." A section 401(k) plan may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make contributions to the section 401(k) plan. Alternatively, a plan may provide that elective contributions are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (i.e., affirmatively elects not to make contributions or to make contributions at a different rate). Arrangements that operate in the second manner are sometimes referred to as "automatic enrollment" plans.

In a section 401(k) plan, the employee must have an effective opportunity to elect to receive cash in lieu of contributions. Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.[35]

Pension Protection Act of 2006

The Pension Protection Act of 2006 ("PPA")[36] added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans as well as section 403(b) plans and section 457(b) plans. Use of any of the special rules is predicated on a default contribution that is a stated percentage of compensation which applies uniformly to all participants. In addition, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment,

[35] Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

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

and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.

The PPA also made changes to ERISA to permit the DOL to provide a safe harbor default investment option and to preempt State laws if certain requirements are satisfied.[37] Specifically, PPA amended ERISA to provide that a participant in an individual account plan with automatic enrollment is treated as exercising control over the assets which in the absence of an investment election are invested in accordance with regulations prescribed by the Secretary of Labor.

Under the DOL's PPA regulations, which were issued October 24, 2007, the default investment option for those automatically enrolled must be a qualified default investment alternative ("QDIA").[38] The choices for a QDIA include: (1) a product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund); (2) an investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally managed account); (3) a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and (4) a capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax). In addition, a QDIA must be managed by an investment manager, plan trustee, plan sponsor, a committee comprised primarily of employees of the plan sponsor that is a named fiduciary, or an investment company registered under the Investment Company Act of 1940. Further, a QDIA generally may not invest participant contributions in employer securities.

Tax credit for small employer pension plan start-up costs

Present law provides for a tax credit under section 45E for small employer pension plan start-up costs for the first three years of the plan. The credit is limited to the lesser of $500 per year or 50 percent of the start-up costs for a qualified plan meeting the requirements of section 401(a), an annuity plan described in 403(a), a SEP, or a SIMPLE retirement plan. Start-up costs associated with a payroll deduction IRA are not eligible for the tax credit.

Description of Proposal

Automatic payroll deduction IRA program

Under the proposal, employers are required to offer an automatic enrollment payroll deduction IRA program to their employees ("automatic payroll deduction IRA program") if the employer (1) has been in existence for at least two years, (2) has more than 10 employees, and (3) does not sponsor a qualified retirement plan, SEP, or SIMPLE IRA plan for its employees. If

[37] Sec. 514 of ERISA.

[38] Labor Reg. sec. 2550.404c-5.

an employer sponsors such a retirement plan, but excludes from eligibility a portion of the of the employers' employees (other than excludable employees[39]) or a class of employees, such as all employees of a subsidiary or division, the employer is required to offer to those non-excludable employees the opportunity to participate in an automatic payroll deduction IRA program.

Employers offering an automatic payroll deduction IRA program must give employees a standard notice and election form informing them of the automatic payroll deduction IRA option and allowing them to elect to participate or to opt-out. For any employee who fails to make an affirmative election in writing under the payroll deduction IRA program, the proposal includes a default under which payroll deduction contributions for the employee automatically begin to be made to an IRA established for the employee. Under the proposal, the automatic enrollment contribution rate for employees who fail to make an affirmative election would be three percent of compensation (but not more than the IRA dollar limit for the year). Employees could opt for a lower or higher contribution rate up to the IRA dollar limit for the year. Employee contributions to automatic IRAs would qualify for the saver's credit under section 25B (to the extent the employee and the contributions otherwise qualify for the credit). Employers making automatic payroll deduction IRAs available would not be responsible for opening IRAs for employees. Payroll deduction contributions from participating employees may be transferred, at the employer's option, to a single private sector IRA trustee or custodian designated by the employer or, if permitted by the employer, to the IRA provider designated by each participating employee. Alternatively, the employer could designate that all contributions would be forwarded to a savings vehicle specified by statute or regulation.

Employers would not be responsible for choosing or arranging default investments or other investment options under the proposal. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed. The proposal generally does not involve liability under ERISA and does not involve any employer contributions, employer compliance with plan qualification requirements. A national website would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Under the proposal, the default under an automatic payroll deduction IRA program is a Roth IRA, though employees may elect to direct their contributions to a traditional IRA. The proposal also specifies a number of administrative requirements that must be satisfied, including a required notice of the right to opt out or contribute a different amount, an election period, and specific timing requirements for the employer to make contributions. However, administrative rules would be designed to minimize administrative costs.

An excise tax, equal to $100 for each participant to whom the failure relates, applies to the failure of any employer to satisfy the automatic IRA requirements for any year.

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[39] Under the proposal, excludable employees are employees excluded from a qualified employer plan pursuant to section 410(b)(3) (allowing exclusion of nonresident aliens and certain employees included in a unit of employees covered by a collective bargaining agreement) or to section 410(b)(4) (allowing exclusion of employees under 21 or having less than one year of service).

Tax credit for automatic payroll deduction IRA program start-up costs

The proposal provides a tax credit for employers for the first two years in which the employer maintains an automatic payroll deduction IRA program. The amount of the credit is equal to $25 multiplied by the number of applicable employees for whom contributions are made, not to exceed $250 for the year.

The proposal also increases the tax credit under section 45E for small employer plan pension start-up costs from the current maximum of $500 per year for three years to $1,000 per year for three years. The increased credit does not apply to an automatic payroll deduction IRA program or other payroll deduction IRAs.

Effective date.−The proposal is effective January 1, 2013.

Analysis

In general

Advocates of this proposal argue that the proposal will promote retirement savings by employees who do not have access to an employer sponsored retirement plan. Advocates point out that the use of automatic enrollment increases employee participation in section 401(k) plans because providing contributions to the employee's account under the section 401(k) plan rather than cash in the employee's paycheck as a default takes advantage of the inertia of employees who fail to take action and simplifies the process for employees by eliminating the need for employees to make decisions as to the rate of contribution or the investment of the contributions.[40] They argue that this same inertia will increase saving in IRAs if employers are required to automatically enroll employees in payroll deduction IRAs. In addition, employees would not need to make a decision as to the financial institution at which to establish an IRA or whether to contribute to a Roth or traditional IRA. Advocates for the proposal also argue that an employer mandate for automatic IRAs will involve little cost to employers because the employer is merely a conduit for the IRA contribution, similar to direct deposit of an employee's paycheck to the employee's bank account.[41]

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[40] James J. Choi, David Laibson, Brigitte C. Madrian and Andrew Metrick, "For Better or Worse: Default Effects and 401(k) Savings Behavior," NBER Working Paper No. W8651. The authors studied three firms that adopted automatic enrollment in their section 401(k) plan. They comment on the effect as follows p. 5. "We find that automatic enrollment has a dramatic effect on participation rates. Under automatic enrollment, 401(k) participation rates exceed 85 percent in all three companies regardless of the tenure of the employee. Prior to auto enrollment, 401(k) participation rate ranged from 26-43 percent after six months of tenure at these three firms and from 57-69 percent after three years of tenure."

[41] J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," in Peter Orszag, J. Mark Iwry, and William G. Gale, eds., *Aging Gracefully: Ideas to Improve Retirement Security in America*, The Century Foundation Press, New York (2006), p. 40.

Potential employee behavior

In addition to producing a general increase in participation comparable to that associated with automatic enrollment in section 401(k) plans, advocates for the proposal believe that mandatory automatic payroll deduction IRAs can be expected to increase contributions to IRAs by low-income and middle-income employees in particular.[42] They believe that these employees are likely to continue to make contributions once they begin the habit of retirement savings. The theory is that to the extent that these employees are not saving for retirement due to inertia (simple failure to take initiative), that same failure to take initiative may prevent them from electing out of the automatic contributions. By requiring an affirmative decision not to save in order to stop the contributions, advocates argue the proposal, at a minimum, would force employees to think about retirement savings. In the case of employees who can and want to save for retirement, the proposal will simplify implementing this decision. Advocates also point out that the use of payroll deduction means the individual is not required to come up with a substantial amount of funds at a single time to meet minimum deposit requirements imposed by many financial institutions offering IRAs. However, many financial institutions require no more than $500 to open an IRA, which is not necessarily substantial. This requirement could be satisfied if an individual saves $40 a month during the year and then opens the account with this savings.

Others point out that there is also evidence that lower-income and middle-income employees participating in present law section 401(k) plans with automatic enrollment who do not opt out of contributing are the most likely to remain at the default contribution rate rather than electing a higher contribution rate.[43] They also point out that many who remain at the default rate might not have elected to participate at all without the automatic feature.

Nevertheless, some argue that certain employees currently do not save for retirement because they need all of their income to meet their basic needs, or retirement savings may be trumped by current savings, or repayment of loans, or for other purposes, such as the purchase of a home or a durable good (e.g., an automobile). They also argue that other employees may choose to spend their current income to finance a lifestyle that they wish to maintain. They point out that an automatic IRA may not change this behavior, especially to the extent that it is easy for an individual to opt out of participation.[44] Opting out may be particularly likely in the case of individuals who are already in a negative savings position.

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[42] Choi, Laibson, Madrian, and Metric, p. 22 found that "automatic enrollment [in section 401(k) plans] does increase wealth accumulation in the lower tail of the wealth distribution by dramatically reducing the fraction of employees that do not participate in the 401(k) plan."

[43] Choi, Laibson, Madrian, and Metric, p. 17 found that "relative to employees in the top third of the pay distribution, employees in the bottom and middle of the pay distribution are much more likely to be at the default."

[44] One empirical study, however, found the likelihood of opting out to be small. This opt out may not be as likely as one might expect. In James J. Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," in Edward J. McCaffery and Joel Slemrod (eds.), *Behavioral Public Finance*, Russell Sage Foundation (2006), p. 304-351, the authors found that, before automatic enrollment 1.9 to 2.6 percent of employees who enrolled drop enrollment in a 12 month period, but the increased rate of dropping for a

Proponents of the proposal could respond to such criticisms by arguing that automatic enrollment in payroll deduction IRAs is not likely to raise the same employee liquidity concerns that are associated with automatic enrollment in section 401(k) plans due to the distribution restrictions under section 401(k) plans,[45] making it less likely that employees will elect out of automatic enrollment under a payroll deduction IRA program. For example, contributions to an IRA for a year are permitted to be withdrawn from an IRA (with allocable income) without tax consequence until the individual's due date for filing the income tax return for the year.[46] Even after the deadline, amounts can be withdrawn, although the early distribution tax may apply for distributions before age 59½. In addition, unlike section 401(k) plan contributions, a payroll deduction contribution to a traditional IRA is deductible without regard to the timing of the election to make the contribution.

Some argue that the ultimate success of an automatic payroll deduction IRA program is not only how much money employees contribute to IRAs through the program, but how much is retained as savings for use in retirement. Others point out that there may be social benefits from pure savings, regardless of whether they are used in retirement. National savings may increase as a result; individuals can be better prepared for unanticipated expenses or changes in their financial situation, such as a job loss. However, national saving does not necessarily increase under the proposal to the extent that other planned saving is diverted into the automatic IRA. Others point out that savings alone do not provide for a secure retirement if the savings are not retained for consumption during retirement.

Historically, there have been significant early withdrawals over time from IRAs, as reflected in the distributions made that are subject to the early distribution tax.[47] These withdrawals do not include distributions made pursuant to an exception to the tax. Opponents of the proposal argue that those who save as a result of the inertia of automatic enrollment may be more likely to take distributions even if they are required to pay the 10-percent early distribution tax. In the case of a Roth IRA, to the extent that only the amount of contributions is withdrawn, any tax-based deterrent to withdrawal is reduced because the distributed amounts are not includable in gross income or subject to the 10-percent early distribution tax. Others respond that a counter-balance against withdrawal from an IRA, in contrast to withdrawal from a section 401(k) account, is that there is no natural withdrawal event from an IRA, such as termination

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plan with automatic enrollment was only 0.3 to 0.6 percentage points higher than that for a plan without automatic enrollment.

[45] Sec 401(k)(2) provides that distributions from a section 401(k) plan are generally only permitted after the employee attains age 59½ (or after death, due to disability, or after severance from employment, if earlier). However, elective contributions to a section 401(k) plan may be distributed on account of hardship.

[46] This unwind of contributions is permitted under section 408(d)(4).

[47] Based on tabulations of tax return data, in 2005, there were about 2.2 million returns with primary and secondary taxpayers age 59 and younger who had taxable IRA distributions. These taxpayers had taxable IRA and pension distributions of about $30 billion. About 1.2 million of these returns were subject to the additional 10-percent tax on over $13.2 billion of early distributions. Stated differently, about 56 percent of the number of taxable IRA and pension distributions received by taxpayers 59 and younger with a taxable IRA distribution appear to have qualified for an exception from the additional early withdrawal tax.

from employment, which is likely to precipitate a withdrawal. Thus, inertia also may help keep the funds in the IRA.

Potential employer behavior

Some argue that the success of the program may depend, at least in part, on how it is received by employers. The employers that would be required to establish an automatic IRA program are generally employers that do not currently sponsor any retirement plan for their employees.

Advocates for the proposal argue that, for some employers, the failure to offer a plan may be the result of the same inertia that causes employees to fail to set up an IRA. They further argue that other employers may desire to establish a plan, but do not because of administrative cost or potential liability issues. For these employers, a required program may facilitate action that they already wanted to take. Advocates are optimistic that such participation may introduce these employers to retirement plan service providers who may in turn more easily induce them to set up an employer-sponsored retirement plan, such as a SIMPLE IRA plan or a section 401(k) plan.[48]

Not everyone agrees, however, with the argument that there will be little cost to employers. Some view the cost as being potentially significant. The ultimate cost to employers will likely depend on how the proposal is designed.[49] While the cost may be less significant than the cost associated with qualified employer plans, administrative costs and issues will be relevant in the establishment of an automatic IRA program. An employer will need to take action to establish a program. The employer will need to have a procedure for establishing default IRAs for employees and must institute notice procedures to inform employees that automatic enrollment will occur absent their affirmative election. In addition, the employer must have resources to address employee concerns and questions about the program. In response to these arguments, the proposal is designed to minimize these administrative costs, but will not eliminate them entirely. The proposal also provides small employers a tax credit with a maximum of $250 for the first two years to reduce this cost. Some have noted, however, that this tax credit, similar to most business tax credits (including the present law credit for small employer plan start up costs), will be of no benefit to small employers that are tax-exempt or who do not have a Federal

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[48] Iwry and John, p. 71.

[49] Mary M. Schmitt and Judy Xanthopoulos, "Automatic IRAs: Are They Administratively Feasible, What are the Costs to Employers and the Federal Government, and Will They Increase Retirement Savings," Preliminary Report Prepared for AARP, Optimal Strategies, LLC (March 8, 2007), p. 13. The report indicates that, in addition to cost to employers, costs associated with automatic IRAs to individual participants may erode the accounts significantly. However, in Mary M. Schmitt and Judy Xanthopoulos, "Administering Automatic IRAs," Report Prepared for AARP, Optimal Strategies, LLC (October 17, 2007), the authors discuss how the costs can be reduced depending on how the proposal is implemented. In Mary M. Schmitt and Judy Xanthopoulos, "Most Small Employers Face Low Costs to Implement Automatic IRAs," Optimal Strategies, LLC (June 24, 2009), the authors point out that automatic payroll systems would reduce cost of automatic IRAs and that most small employers now use automated payroll systems.

tax liability for a given year (except to the extent the employer can use the permitted carry forward).

Advocates of the proposal recognize that the success of the program depends on streamlining compliance requirements for employers so that the cost of compliance is relatively low, and that success may depend on the implementation of the program by the Internal Revenue Service or other responsible agency. Advocates argue that the proposal is designed to be as administratively streamlined as possible, including a provision under which employers will not be required to open IRAs on behalf of employees. They point out that the proposal indicates that a low-cost standard default investment will be provided, which will help to lower employer cost of administration because the employer will not need to select a default investment and will limit the employer's potential liability for a poor choice.

Opponents argue that some employers may have deliberately decided not to maintain an employer sponsored retirement plan for their employees. Under current law, other than withholding and paying payroll taxes to fund social security benefits, sponsorship of a retirement plan by an employer is voluntary. Opponents argue that the low level of voluntary establishment of payroll deduction IRA programs by employers who do not sponsor qualified retirement plans is not entirely due to inertia. An employer might have made a judgment that further payroll deductions of any kind, let alone an automatic program, is not a program that their employees, particularly minimum wage employees, would value. The employer might assume that these employees will not be able to afford any further reduction in take-home pay.

Some argue that the mandatory element of the proposal might generate resentment by certain employers and resistance to embracing the program as a benefit for their employees. They argue that the level of compliance among these employers may depend on the level of enforcement by the IRS. They further point out that an employer could present the option to employees in a way that is more likely to generate an election not to contribute than an election to make contributions.

Advocates of the proposal acknowledge that the program must be carefully designed so as not to result in the elimination or scaling back of existing employer-sponsored retirement plans, such as a section 401(k) or SIMPLE IRA plans, or the failure to adopt such plans. Some have argued that, because the proposal is designed to relieve employers of many of the burdens associated with sponsoring a qualified plan, small businesses may decide to limit employees' opportunity to save for retirement on a tax-favored basis to their ability to contribute to the automatic IRA program. Because the limits on contributions to the program are lower than those that apply to contributions to other qualified plans, this would have a negative impact on the amount of retirement savings some individuals would otherwise accumulate under an employer-sponsored plan.

Others have noted, however, that the desire of small business owners to take advantage of the greater tax-deferred savings, including the option of making employer contributions, offered under a qualified plan (allocations up to $49,000 for 2011 are permitted) will continue to provide an incentive to sponsor such plans, regardless of any relative cost savings associated with offering only the automatic IRA program (which would permit contirbutions onlyup to the IRA limit, currently $,5,000 (or $6,0000 for those over age 50). The rules prohibiting discrimination

in favor of owners and other highly compensated employees prevent small-business owners from taking advantage of this higher limit on contributions without providing benefits for rank and file employees. Finally, the proposal doubles the current start-up cost credit available under section 45E to $1,000 per year for three years. Advocates believe that this expanded credit will encourage small employers to adopt a new employer-sponsored retirement plan, rather than an automatic IRA program.

Financial institutions

In the absence of a proposal that mandates a Federal or State program to accommodate the new small IRAs that will be established, some argue that the financial community would need to embrace the program to make it feasible. Many of the employees who elect, or default into, participation will have no preexisting IRAs. Some will have no current relationship with any financial service provider. For low-income and middle-income employees, the initial contributions will be very small. For example, three percent of weekly pay of $500 is only $15. Most financial institutions charge small annual fees for IRA maintenance and many require minimum contributions to establish an IRA.[50] These fees and minimums may be a significant barrier to making default IRAs attractive to low-income or even middle-income taxpayers. Thus, even advocates of the proposal recognize that providing low-cost options as suggested in the proposal may be a critical element in a successful program.

Paternalism

The proposal makes mandatory an option that is already available under present law. Individuals are free to contribute to IRAs, subject to certain qualifications, and employers are free to establish payroll deduction IRAs. Employers may even be able to enroll employees in payroll deduction IRAs automatically under PPA changes to ERISA.[51] However, the proposal simplifies some of these opportunities. Proponents have expressed the belief that targeted individuals save insufficiently for retirement despite these opportunities. By mandating automatic enrollment, proponents hope to increase the take up rate of IRAs among the targeted employees in a way that they believe will improve their well being. Some make a case for paternalistic intervention on the grounds that individuals do not act in their own best interest because of limits on individual rationality, a lack of information, or inertia.[52] Some argue that setting the default rule to contribute to an IRA with the ability to opt out, as opposed to the default rule being nonparticipation with the option of affirmative action to contribute, may be viewed as an example of soft, or libertarian, paternalism.[53] Advocates define paternalism as

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[50] *Ibid.*, p. 44. The report discusses the problem of small automatic IRA contributions including current minimum monthly contributions and annual administrative fees. The report suggests pooling of automatic contributions to reduce administrative fees with respect to automatic accounts.

[51] Under present law, this level of employer involvement may constitute an endorsement of the default IRA and cause the automatic payroll deduction IRA program to be a pension plan under ERISA.

[52] H. Rep. No. 109-232 Part 1 that accompanied H.R. 2830 (September 22, 2005), p. 280.

[53] See Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," *American Economic Review Papers and Proceedings*, 93 (May 2003), pp. 175-179.

choosing a policy with the goal of influencing the choices of affected parties in a way that will make those parties better off, and such paternalism is libertarian if no coercion is involved. Others would argue that only voluntarily entered rules are free from coercion.[54] One might view the desirability of a policy differently, or hold it to a higher standard to judge its desirability, if coercion is involved. Some argue that "flaws in human cognition," such as those identified above, "should make us more, not less, wary about trusting government decision making" and that while "soft paternalism is less damaging than hard paternalism…[s]oft paternalism is neither innocuous nor obviously benign."[55]

Protection of employees against employer retaining deducted contributions

The Department of Labor ("DOL") has found numerous instances where employers have deducted amounts from an employee's pay for contribution to a section 401(k) plan but failed to contribute the amount to the plan.[56] In the case of a section 401(k) plan, such failure can result in excise taxes, civil penalties, and even criminal prosecution.[57] The DOL has found that the employee may not be aware that the contributions are not being made until the employee receives his or her account statement.[58] As a result, some argue that it is important that any proposal include comparable protection for employees to those provided to participants under a section 401(k) plan against these potential abuses by employers. Advocates may respond that there are State laws that prevent misuse of employer funds. One approach advocated by some is to mandate that all default contributions be made to a government-sponsored IRA and that all employees have a government sponsored IRA as an investment option. They argue that such a

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[54] See Daniel B. Klein, "Statist Quo Bias," *Econ Journal Watch*, 1(2) (August 2004), pp. 260-271; Cass R. Sunstein "Response to Klein," *Econ Journal Watch*, 1(2) (August 2004), pp. 272-273; and Daniel B. Klein, "Reply to Sunstein," *Econ Journal Watch*, 1(2) (August 2004), pp. 274-276.

[55] Edward L. Glaeser, "Paternalism and Psychology," *University of Chicago Law Review*, 73 (2006), pp. 133-156.

[56] Since 1995, the DOL has emphasized 401(k) abuse as a national enforcement initiative. The DOL reports the following 401(k) enforcement initiative results for fiscal years 2007 and 2008: for fiscal year 2008, a total of 1,232 civil investigations were closed, with 1,072 corrected violations and monetary results of $24,863,198 nationwide; for fiscal year 2007, 1,326 civil and criminal investigations were closed with 1,133 corrected violations and monetary results of $51,294,250 nationwide. Fact Sheet: Retirement Security Initiatives, U.S. Department of Labor, Employee Benefits Security Administration, http://www.dol.gov/ebsa/erisa_enforcement.html#section6.

[57] Under Department of Labor ("DOL") Reg. sec. 2510.3-102, an amount withheld from an employee's wages for contribution to a section 401(k) plan becomes part of the assets of the pension plan for purposes of ERISA protections as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. An employer holding these assets after that date commingled with its general assets is engaging in a prohibited use of plan assets under section 406 of ERISA, which generally prohibits a plan fiduciary from engaging in prohibited transactions. The DOL has a correction program that allows employers to voluntarily correct violations under certain circumstances under its Voluntary Fiduciary Correction Program, published in the *Federal Register* on March 28, 2002 (67 FR 15061).

[58] For employees, the DOL includes on its website a list of 10 warning signs that 401(k) contributions are being misused. Examples of the warnings signs listed include the employee's account statement shows a contribution from a paycheck was not made and that the employer has recently experienced severe financial distress (http://www.dol.gov/ebsa/Publications/10warningsigns.html).

requirement could make it easier to establish a mechanism for regularly monitoring whether contributions were being made in a timely manner.

Traditional or Roth IRA as the default

Under the proposal, the default is a Roth IRA. The designation of Roth IRAs as a default removes one potential complexity for employers and employees, but may also have immediate and long-term tax consequences for employees. For example, as discussed above, the maximum contribution that can be made to a Roth IRA is phased out for taxpayers with AGI over certain levels (for 2011, for single taxpayers, $107,000 to $122,000, and for married taxpayers filing jointly, $169,000 to $179,000). There is no income limit for nondeductible contributions to a traditional IRA and no income limit for deductible contributions if the taxpayer (or, if married, both taxpayer and spouse) does not participate in an employer-sponsored plan. Thus, many argue that, to the extent no default is provided, an employer is likely to choose a traditional IRA as a default so that higher income employees will not be subject to excise taxes for excess contributions.

However, some argue that, for many taxpayers, a Roth IRA may be a better choice. Lower income taxpayers may have a lower marginal rate currently than when they receive distributions, making a deduction today for a traditional IRA less valuable and less of a motivation for retirement savings than would be the alternative exclusion for income from a Roth IRA in retirement. While it is generally the case that the lower one's income, the lower one's marginal tax rate, some lower income taxpayers can have a quite high effective marginal tax rate as a result of the phaseout of the earned income tax credit. These same taxpayers may face further increases in their effective marginal tax rates as a result of the phaseout of the newly enacted tax credit for individuals and families who purchase health insurance through a State health insurance exchange. Hence, many low- and middle-income taxpayers might be better off if the default is a traditional IRA rather than a Roth IRA.

Additionally, lower income employees may prefer to contribute to a Roth IRA because funds in a Roth IRA may be distributed prior to retirement age with fewer penalties than distributions from traditional IRAs. Roth distributions are allocated first to basis and received tax free (and thus also not subject to the 10 percent early distribution tax) until all contributions are distributed. In contrast, any distribution attributable to deductible contributions is fully includible in gross income and subject to the early-distribution tax unless an exception applies.

Finally, even for individuals who benefit from the ability to make deductible contributions to a traditional IRA (i.e., higher income employees), a contribution to a Roth IRA of the maximum amount (to the extent allowed by the income limits) will produce more income at retirement because a dollar contributed to a Roth account represents greater after-tax savings than a dollar contributed to a traditional deductible IRA, because the former is contributed on an after-tax basis while the latter is contributed on a pre-tax basis. Still, higher-income employees may be unable to make regular Roth contributions because of the income limits. In addition, taxpayers making contributions to a Roth IRA are required to include the amount of the contributions in AGI rather than being allowed to deduct it, further diminishing the individual's current after-tax disposal income, a potentially greater concern for lower income taxpayers.

Prior Action

A similar proposal was included in the President's fiscal year 2010 and 2011 budget proposals.

E. Extend American Opportunity Tax Credit

Present Law

Hope credit

For taxable years beginning before 2009 and after 2012, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,800 (for 2008) 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.[59] The Hope credit rate is 100 percent on the first $1,200 of qualified tuition and related expenses, and 50 percent on the next $1,200 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 $1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phaseout described below) for a $1,200 Hope credit. If a taxpayer incurs $2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a $1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $48,000 and $58,000 ($96,000 and $116,000 for married taxpayers filing a joint return) for 2008. 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 are always $10,000 and $20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified

[59] Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2012.

tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.[60]

The Hope credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Effective for taxable years beginning after December 31, 2012, the changes to the Hope credit made by Economic Growth and Tax Relief Reconciliation Act of 2001, as modified by the

[60] The above-the-line deduction for qualified tuition and related expenses is not available for taxable years beginning after December 31, 2011. However, a separate proposal contained in the President's fiscal year 2012 budget extends this deduction for one year, so that it is available for taxable years beginning before January 1, 2013.

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("EGTRRA"), no longer apply.[61] The principal EGTRRA change scheduled to expire is the change that permits a taxpayer to claim a Hope credit in the same year that he or she claims an exclusion from a Coverdell education savings account. Thus, after 2012, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

American Opportunity Tax Credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009, 2010, and 2011. 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, 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.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

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.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Description of Proposal

The proposal expands the present law Hope credit so as to make permanent the temporary modifications to the Hope credit for taxable years beginning in 2009, 2010, and 2011 that are known as the American Opportunity Tax Credit. In addition, the proposal renames the Hope credit the American Opportunity Tax Credit.

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[61] A separate proposal contained in the President's fiscal year 2012 budget permanently extends the changes to the Hope credit made by EGTRRA. See Part XIII.G of this document for a description of that proposal.

The dollar amounts to which the 100-percent and 25-percent credit rates are applied are indexed for inflation, with the amounts rounded down to the next lowest multiple of $100. The AGI phaseout ranges are also indexed for inflation, with the amounts rounded down to the next lowest multiple of $1,000.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2012.

Analysis

The present-law modifications to the Hope credit, referred to as the American Opportunity Tax Credit, are intended to provide some financial relief to taxpayers faced with increasing tuition costs. The proposal makes the American Opportunity Tax Credit modifications permanent. By increasing the amount of the credit, the phaseout levels, and the number of years of education with respect to which the credit may be claimed, the modifications increase the number of taxpayers who may claim the credit and the amount of credit that those taxpayers may claim. In addition, because the modifications make a portion of the credit refundable, additional people (i.e., those with no Federal income tax liability) may benefit from the credit.

Some people observe that the cost of post-secondary education has increased at a rate in excess of the rate of inflation for nearly 30 years, with the result that it is becoming an ever greater financial burden for individuals to pursue a college education. These people contend that making the American Opportunity Tax Credit permanent will help to mitigate some of this burden. Other people observe that the acquisition of a college degree provides enormous benefits to an individual (e.g., greater lifetime earning potential and increased job opportunities) that are sufficient to justify the cost of acquiring the degree, and that these benefits have increased over time.[62] If the cost of obtaining a college degree were to exceed the resulting benefits, one would expect to see a decrease in the number of individuals pursuing a degree until such time as the costs decrease and/or the benefits increase. As of yet, such a decline in college attendance has not occurred.[63]

Other people argue that some individuals who desire to go to college are unable to do so because they do not have the funds to pay for the education and are unable to borrow the necessary amounts (because, for example, it is difficult to pledge increased future earning potential as security for a loan). For these potential students, a generous government subsidy in the form of the American Opportunity Tax Credit may make up for the deficiency in funding and enable them to pursue the college degree that they desire. In response to this argument, some people observe that there already exist a large variety of programs, available from both the public

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[62] See, e.g., Thomas Lemieux, "Postsecondary Education and Increasing Wage Inequality," *American Economic Review* 96 (May 2006), pp. 195-99.

[63] See Thomas D. Snyder, Sally A. Dillow, and Charlene M. Hoffman, National Center for Education Statistics, U.S. Department of Education, *Digest of Education Statistics 2008* (NCES 2009-020) (March 2009), p. 269, *available at* http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2009020.

and private sectors, which are designed to help students to afford college, including various loan programs, merit-based assistance programs, and need-based assistance programs (e.g., the Pell Grant program).

Another aspect of the proposal that merits discussion is that it provides for permanent, partial refundability of the credit. Some argue that credits for education expenses should be refundable to subsidize education for low-income individuals who need the subsidy the most but may have insufficient tax liability to realize the benefit of the Hope credit (without the temporary modifications of the American Opportunity Tax Credit). Others argue that refundable tax credits are administratively complex and that there are Federal spending programs, such as the Pell Grant program, that provide direct grants for education to a demographic group of individuals that is generally similar to the group that would be eligible for the permanent, refundable credit.[64] They also argue that the Pell Grant has the advantage of providing its subsidy at the time the education expense is incurred, whereas a refundable credit, unless made advanced-refundable, would provide the subsidy after the education expenses are incurred when the tax return is filed and processed.[65]

Lastly, an issue that affects tax incentives, such as the American Opportunity Tax Credit, as well as direct expenditures to subsidize education, concerns the ultimate economic incidence of the subsidies as compared to the statutory beneficiary. For example, it has been observed that the various individual tax benefits for education (such as the present-law Hope credit) provide incentives for educational institutions to capture some of the benefit by raising their tuition and fees. This observation is particularly true for community colleges that charge less than the amount that is fully subsidized by the Hope credit (e.g., the first $1,200 of tuition in 2008 is eligible for a 100-percent credit for Hope eligible students), because tuition can be raised to $1,200 without the student paying more out of-pocket on an after-tax basis, provided the student or parent has tax liability to offset.[66] Additionally, State and local governments may choose to appropriate fewer funds to the public educational institutions or to financial aid programs in response to the increased support provided by the Federal government via individual tax incentives.[67] These responses by educational institutions and/or State and local governments

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[64] In a separate, nontax proposal, the President's budget proposes to make certain modifications to the Pell Grant program, including maintaining the current maximum Pell Grant award of $5,550, verifying data to reduce net overpayments, repealing the year-round Pell program, and introducing student aid reforms. Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government: Fiscal Year 2012* (H. Doc. 112-3) (2011), Vol. III, pp. 154-56.

[65] The ability to obtain a loan from the educational institution or another source with the expected credit as security would mitigate this concern. However, some people have raised concerns about the high cost of some loans that are made in anticipation of tax refunds.

[66] For students who do not have income tax liability to offset, the college may offer additional scholarship amounts to offset the tuition increase so that these students pay the same out-of-pocket amount as they did before the college attempted to capture the subsidy.

[67] For evidence on the response of educational institutions with respect to tuition policy and governments with respect to appropriations for education, see Bridgett Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It,* Caroline M. Hoxby ed. (2004), p. 101.

have the potential to undermine the benefit provided at the Federal level. In particular, to the extent that colleges raise tuition in response to a Federal nonrefundable (or only partially refundable) credit, students or parents without Federal tax liability to offset are made worse off.

This last issue of who is the ultimate economic beneficiary of a particular tax benefit for education may be an even greater concern under the American Opportunity Tax Credit and the proposal to make it permanent because this credit provides an even larger subsidy than the present-law Hope credit. In particular, the American Opportunity Tax Credit increases the amount of tuition that is fully subsidized to $2,000 per year (from $1,200 in 2008). As a result of this change, a college that wishes to capture as much of the subsidy as possible may now have an incentive to raise tuition to at least $2,000. In addition, the American Opportunity Tax Credit substantially raises the income phaseout amounts. Thus, a college that wishes to capture as much of the subsidy as possible now may need to be less concerned that students will be ineligible for the credit (due to their high income) and face increased out-of-pocket costs—the vast majority of Americans have incomes below the new phaseout amounts. Finally, the American Opportunity Tax Credit makes 40 percent of the credit refundable. This change means that a college that wishes to capture as much of the subsidy as possible now may need to be less concerned that students will not benefit from the credit because they have no tax liability. In fact, a college that wishes to leave these students with no increased out-of-pocket costs (e.g., by providing increased scholarship amounts to offset subsidy-capturing tuition increases), may nevertheless be able to capture the refundable portion of the credit.

Prior Action

A similar proposal was included in the President's fiscal year 2010 and 2011 budget proposals.

F. Provide Exclusion from Income for Certain Student Loan Forgiveness

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.[68]

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

Students with higher education expenses may be eligible to borrow money for their education through the Federal Direct Loan Program. Prior to July 1, 2010, they may also have been eligible to borrow money through the Federal Family Education Loan Program. Both programs are administered by the Department of Education. Each program provides borrowers with an option for repaying the loan that is related to the borrower's income level after college (the income-contingent and the income-based repayment options). Under both of these options

[68] Sec. 108(f).

borrowers complete their repayment obligation when they have repaid the loan in full, with interest, or have made those payments that are required under the plan for 25 years. For those who reach the 25-year point, any remaining loan balance is forgiven. Under current law, any debt forgiven by these programs is considered gross income to the borrower and thus subject to individual income tax.

The proposal would exclude from gross income amounts forgiven at the end of the repayment period for Federal student loans using the income-contingent repayment option or the income based repayment option.

Effective date.−The provision is effective for loans forgiven after December 31, 2011.

Analysis

The tax code does not treat borrowed resources as income, as there is an obligation to repay, and it does not treat the principal repayment of borrowed resources as a deductible expense. When the obligation to repay a debt is cancelled, the taxpayer experiences a net increase in resources, and the tax code generally treats this increase in resources as income. The proposal thus contravenes general tax code principles that treat cancellation of indebtedness as income, and would provide an additional Federal subsidy to the borrower beyond that represented by the debt cancellation itself.

Some argue that the purpose of the underlying program of debt cancellation is contradicted by imposing a potential tax obligation when the debt is cancelled after 25 years of repayment. They might further argue that the proposed income exclusion is warranted to provide additional encouragement for the pursuit of careers that might provide important social benefits but that are not very remunerative. Others might argue that the general tax code principles should not be violated in pursuit of this goal, and that any desired additional subsidies for education or borrowing be provided directly from the budget of the Department of Education.

It is argued that the potential tax consequences of debt forgiveness might prevent some from accepting the forgiveness of the loan, thus undermining the intent of the debt cancellation program. To the extent that that is a problem, a solution other than cancelling the income tax obligation might be for the Department of Education to establish a modest short term loan program to help the taxpayer finance the tax obligation.

Prior Action

No prior action.

G. Tax Qualified Dividends and Net Long-Term Capital Gains at a 20-Percent Rate for Upper-Income Taxpayers

Present Law

Dividends

In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax rates before 2013

An individual's qualified dividend income is taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2013, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Qualified dividend income 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.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

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 dividends qualifying for reduced rates 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.

The reduced rates do not apply to 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.[69]

Tax rates after 2012

For taxable years beginning after 2012, all dividends received by an individual are taxed at ordinary income tax rates.

Capital gains

In general

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. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

[69] In addition, for taxable years beginning before 2013, amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

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

Tax rates before 2013

Under present law, for taxable years beginning before January 1, 2013, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the AMT.

Under present law, 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).

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" 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.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 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.

Tax rates after 2012

For taxable years beginning after December 31, 2012, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital gain rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2013.

Description of Proposal

Under the proposal, the tax rates in effect before 2013 are made permanent for adjusted net capital gain and qualified dividend income otherwise taxed at rates below 36 percent. In addition, a 20-percent tax rate will apply to adjusted net capital gain and qualified dividend income which would otherwise be taxed at the 36 or 39.6 percent ordinary income tax rate. The special rates applicable to assets held more than five years are repealed. The rates on 28-percent gain and unrecaptured section 1250 property are retained.

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

Dividends

Under present law, the United States has a "classical" system of taxing corporate income. Under this system, corporations and their shareholders are treated as separate persons. A tax is imposed on the corporation on its taxable income, and after-tax earnings distributed to individual shareholders as dividends are included in the individual's income and taxed at the individual's tax rate. This system creates the so-called "double taxation of dividends." Prior to 2003, corporate dividends received by an individual taxpayer were taxed at the same rate as ordinary income. By reducing the tax rate applicable to dividends in 2003, the Congress hoped to mitigate the double taxation of dividends and the implicit bias in favor of returns received from ownership of corporate equity in the form of capital gains. This was intended to reduce economic distortions.

The classical system, it is argued, results in economic distortions. Economically, the issue is not that dividends are taxed twice, but rather the total tax burden on income from

different investments. Business investments in entities not subject to corporate tax, such as partnerships, limited liability companies, and S corporations generally are taxed more favorably. An investment in a C corporation that returned $100 would pay a $35 corporate income tax and then, if the remaining $65 were paid out as a dividend to a shareholder in the highest individual income tax bracket (presently 35 percent), the shareholder would net $42.25. Had the investment been made through a partnership, the taxpayer would have received $65 ($100 - ($100 multiplied by 35 percent)) after tax. Thus, analysts observe that because a classical system creates different after-tax returns to investments undertaken in different legal forms the choice of legal entity is distorted and economic efficiency is reduced.

Critics of a classical system argue that a classical system distorts corporate financial decisions. They argue that because interest payments on the debt are deductible, while dividends are taxable, a classical system encourages corporations to finance using debt rather than equity. They observe that the increase in corporate leverage, while beneficial to each corporation, may place the economy at risk to more bankruptcies during an economic downturn.

Similarly, a classical system encourages corporations to retain earnings rather than to distribute them as taxable dividends. Drawing on the example above, if the corporation had retained the $65 of income net of the corporate income tax, the value of the corporation should increase by $65. If shareholders sold their shares, under present law they would recognize the $65 as a capital gain and generally incur a $9.75 income tax liability. Thus, a retention policy could result in net income to the shareholder of $55.25 as opposed to $42.25 if income were paid out as a dividend.[70] This difference in effective tax burden may mean that shareholders prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings. This is another source of inefficiency as the opportunity to earn higher pre-tax returns is passed up in favor of lower pre-tax returns. The present-law reduced rate of tax on qualified corporate dividends narrows the difference in effective tax burden between a policy of dividends and a policy of retaining earnings.

Proponents of the reduced rates of tax on dividend income under present law observe that by reducing the aggregate tax burden on investments made by corporations, the proposal would lower the cost of capital needed to finance new investments and may increase investment in the aggregate as well as investment by C corporations. Increased investment ultimately should lead to increased labor productivity, higher real wages, and increased long-term economic growth. However, there is no consensus about the magnitude of the long-run responsiveness of investment to changes in the cost of capital.

The simple examples used above to illustrate potential sources of economic inefficiency in a classical system may overstate the aggregate tax burden on investments made by C corporations. Critics of present law have questioned whether there is a substantial effect on corporate investment because persons not subject to the individual income tax (e.g., foreign

[70] In practice the effective tax rate difference between the dividend policy and retention policy would be greater. This simple example assumes the capital gain is recognized immediately. Taxpayers can choose to defer recognition of gain. By deferring gain, the effective tax burden on the gain declines.

persons and tax-exempt institutions such as pension funds) hold substantial amounts of corporate equity. If these shareholders are the providers of incremental investment funds, present law generally does not change the aggregate tax burden on an investment made by a C corporation. Critics of present law also observe that, in the early years, much of the tax reduction from reduced taxes on dividend income accrues to returns to investments made by C corporations in the past and not new investment. Moreover, critics observe that, as corporate stock when held by individuals outside of tax-favored retirement accounts is generally held more extensively by taxpayers above the median income, the benefit of the present-law reduced rates of tax most directly benefits higher-income taxpayers.

Capital Gains

Both present law and the Administration's proposal would provide for a maximum tax rate on income from realized capital gains that is less than the tax rate applicable to a taxpayer's income from labor (wages and salary) and from other types of capital (for example, interest, non-qualified dividends, and rental income). The differential in tax rates between income from realized capital gains and these other sources raises several policy issues.

- Does a differential rate promote improved efficiency of the capital markets?
- Does a differential rate promote the socially optimal level of risk taking?
- Does a differential rate promote long-run economic growth?
- Is income from capital gains properly measured?
- Is a differential in rates consistent with policy maker's equity goals?

Does a differential rate promote improved efficiency of the capital markets?

Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this "lock-in effect" is exacerbated by the rules that allow a step-up in basis at death and defer or exempt certain gains on sales of homes. As an example of what is meant by the lock-in effect, suppose a taxpayer paid $500 for a stock that now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 20-percent tax rate, if the taxpayer sells the stock one year or more from now (when it is worth $1,100), he or she will net $980 after payment of $120 tax on the gain of $600. With a tax rate on gain of 20 percent, if the taxpayer sold this stock today, he or she would have, after tax of $100 on the gain of $500, $900 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.1 percent. With a tax rate on gain of 28 percent, the alternative investment would need to earn a total pre-tax return in excess of 11.6 percent to justify a switch, while the required rate of return with a 15-percent tax rate is only 10.8 percent. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. When the tax imposed on removing monies from old investments is reduced, taxpayers would not necessarily redirect their funds to new investments when their monies in

older investments are unlocked. Taxpayers might instead choose to consume the proceeds. Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock-in.

To the extent that preferential rates may encourage investments in stock, and more specifically stock that offers its return in the form of capital gain rather than dividends, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Non-neutral treatment generally is not consistent with capital market efficiency. On the other hand, it is argued that asset neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Does a differential rate promote the socially optimal level of risk taking?

Some maintain that a preferential capital gains tax rate encourages investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. In theory, when a tax system accords full offset for capital losses, a reduction in tax rates applicable to capital gains would reduce risk taking. This is because with full loss offset the government acts like a partner in the investment, bearing an equal share of the risk, both good and bad. The reduction in tax rates reduces the government's share in gains and losses such that less risk is necessary to generate the same amount of after-tax income and the investor bears more of any loss.[71] However, the present-law limitation on taxpayers' ability to offset capital losses against other income creates a bias against risk taking by implicitly reducing the value of any loss by deferring its inclusion in income. A reduction in the tax rate on realized gain, proponents argue, therefore should increase risk taking. Proponents argue that the preference provides an incentive for investment and capital formation, with particular importance for venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate, broadly applied, is not targeted toward any particular type of equity investment. They note that a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments. They observe that present-law section 1202 (that provides individual holders of certain small businesses with a reduced tax on realized capital gains) and present-law section 1244 (that provides expanded loss offset for investments in certain small business stock) more specifically target risk-taking activities.

The President's budget proposal also would expand the tax benefit under section 1202 by creating a tax rate of zero for qualified investments.[72] Proponents aver that it is important to

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[71] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," 58 *Quarterly Journal of Economics* (May 1944).

[72] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2012, Analytical Perspectives* (H. Doc. 112-3, Vol. III), p.199.

provide a preference to equity investments in small businesses as they create the industries of the future. Opponents of such a capital gains preference point out that a tax preference could have only a small incentive effect on investment because a large source of venture capital and other equity investment is tax-exempt or partially tax-exempt entities (for example, pension funds and certain insurance companies and foreign investors). For example, in 2008, tax-exempt entities (including public pension funds, endowments, foundations, sovereign wealth funds, and union pension funds) contributed nearly 44 percent of new venture capital funds.[73] On the other hand, proponents argue that preferential capital gains treatment for venture capitalists who are taxable is important. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital. They further observe that initial investors in new ventures are frequently friends and family of the entrepreneur, all of whom are taxable. The organized venture capitalists are more prevalent at later stages of financing. They observe that small businesses face a higher cost of capital than do larger, established businesses. However, a higher cost of capital does not necessarily indicate a market failure for which a tax subsidy might be justified. Small businesses are inherently risky. The majority of small businesses do not survive their first year. A higher cost of capital may only reflect market realities in assuming risk by investors and not a flaw in the capital markets. Others note that the Federal government has developed loan programs administered through the Small Business Administration to address the higher cost of capital faced by many small businesses. Proponents of a reduced capital gains tax rate on equity investments in small businesses argue that unlike the programs of the Small Business Administration, the proposed tax benefit is not limited by the appropriations process and is open to all businesses that meet the qualifying standards. They note that the market would still remain the judge of where to allocate investments among qualifying small businesses.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program. On the other hand, the capital gains preference may make equity more attractive than debt, the returns on which are taxed at ordinary income tax rates.

Does a differential rate promote long-run economic growth?

The United States has a low rate of household saving, averaging less than five percent of disposable income for more than the past decade.[74] This rate is low both in comparison to other industrialized countries and in comparison to prior United States experience. At the aggregate level, a low saving rate is a concern because saving provides the wherewithal for investment in productivity-enhancing equipment and technology. At the household level, a low saving rate

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[73] Dow Jones Private Equity Analyst, Sources of Capital, 2009, at 4, available at http://www.fis.dowjones.com/products/privateequityanalyst.html

[74] Council of Economic Advisers, *Economic Report of the President*, Washington, D.C.: U.S. Government Printing Office (January 2009), p. 320.

may imply households are accumulating insufficient assets for retirement, emergencies, or other uses. By reducing the tax on realized capital gains, the after-tax return to household saving is increased.

Theoretically, the effect on saving of a reduction of taxes on capital income is ambiguous. There are two effects. First, the increased return to saving should encourage people to save more. Second, the increased return people receive on assets they have already accumulated and on saving they had already planned increases their income. This increased income may encourage them to increase their consumption and may reduce their saving. Empirical economic evidence also is ambiguous on whether, or if at all, household saving responds to changes in the after-tax rate of return.

In addition, reduction in only the tax applicable to capital gains may prove to be an inefficient saving incentive. By favoring certain types of assets (those that generate returns in the form of accrued gains) over other types of assets (those that generate returns in the form of interest, dividends, or royalties), taxpayers may reallocate their holdings of assets to obtain higher after-tax returns without saving new funds. Such portfolio reallocations also represent reduced efficiency of capital markets as choices have been distorted. As noted above, the application of a reduced tax on capital gains to those who currently hold assets with accrued gains could lead to reduced saving as households sell those assets and increase consumption from the proceeds.

Is income from capital gains properly measured?

Some proponents of lower tax rates on income from capital gain observe that the preference may provide taxpayers some rough compensation for inflation. Part of the gain represents the effects of inflation and does not constitute real income.

Others note that a preferential tax rate is a very crude adjustment for inflation. In addition, as income taxed upon realization, generally at the taxpayer's discretion, a taxpayer realizing income from a capital gain enjoys a tax benefit from the deferral of tax on accrued appreciation until the asset is sold. The following example illustrates the benefit of deferral. Assume a taxpayer in the 15-percent tax bracket has $1,000 to invest and may choose between two investment alternatives, each of which generates a return of 10 percent annually. Assume the one investment is a certificate of deposit that pays the 10-percent return out annually as interest on which the taxpayer must pay tax. After paying tax, the taxpayer reinvests the principal and net proceeds in a new certificate of deposit. The other investment, stock in a company that pays no dividends, accrues the 10-percent return untaxed until a capital gain is realized. After eight years the after-tax value of the taxpayer's certificate of deposit would be $1,920.[75] After selling the stock and paying tax on the realized gain, the taxpayer would have

[75] This is calculated as $1,000(1 + r(1 - t))^n$, where r is the interest rate (10 percent in this example), t is the marginal tax rate (15 percent in this example), and n is the number of years the asset is held (eight in this example).

$1,972.[76] Another way to characterize the benefit of deferral is that the effective rate of taxation on realized capital gains is less than the rate of taxation applicable to assets that pay current income. In this particular example, the effective rate of taxation on the realized capital gain is 11.4 percent, rather than the statutory tax rate of 15 percent.[77] On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation.

Is a differential in rates consistent with policy maker's equity goals?

A lower rate of tax for income from capital gains compared to the tax rate applicable to other income will benefit directly those taxpayers who hold assets with accrued capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. Tax return data contain information on which taxpayers have realized capital gains in the past. These data reveal that many taxpayers realize a capital gain from time to time, but the majority of the dollar value of gains realized is by taxpayers who frequently realize capital gains. Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, the bulk of the dollar value of any tax reduction will go to those taxpayers who realize the bulk of the dollar value of gains.

The data also suggest that taxpayers who infrequently realized capital gains generally have lower incomes than those taxpayers who frequently realized capital gains. These findings have been criticized because income is sometimes measured including the realized gain. However, attempts to account for this problem by measuring income less realized gains or by using a measure of income averaged over a period of years generally reveal that a large portion of the dollar value of gains are realized by higher-income taxpayers while a large portion of the transactions in which gains are realized are undertaken by the remaining taxpayers. Such findings are consistent with information on the ownership of assets in the United States. Higher-income taxpayers generally hold a larger proportion of corporate stock and other capital assets than do other taxpayers. Thus, while many taxpayers may benefit from a lower rate of tax on income from capital gains, a larger proportion of the dollar value of a lower tax rate on capital gain income will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.

Complexity and tax rate differentials for income from dividends and capital gains

The combination of present law and the proposed changes of the President's Fiscal Year 2012 budget proposal creates a complex structure of tax rates for different types of investments.

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[76] This is calculated as the $1,000 principal plus the net, after-tax gain of $(1{,}000(1 + r)^n - 1{,}000)(1 - t)$, where r is the interest rate (10 percent), t is the marginal tax rate (15 percent), and n is the number of years the asset is held (eight).

[77] The effective rate of taxation on a realized gain is calculated by asking what rate of tax on an asset that paid current income would yield an equivalent amount of net proceeds to the taxpayer if that asset were held until the taxpayer realized the capital gain.

Tables 1 through 3, below, detail the tax rates applicable to income from different investments yielding income from dividends and capital gains.

Table 1.–Tax Rates Applicable Under Present Law to Certain Categories of Income, 2011-2012

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**35%**	**26%**	**28%**
Qualified dividend income	0	0	15	15	15	15	same as regular tax	
Non-qualified dividend income and short-term capital gain[1]	10	15	25	28	33	35	26	28
Long-term capital gain[2]	0	0	15	15	15	15	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	26	28
Small business stock[4]	0	0	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock[5]	0	0	10	11.2	11.2	11.2	11.592	12.376
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0	0

Table 2.–Tax Rates Applicable Under Present Law to Certain Categories of Income, 2013 and Thereafter

	Regular Tax Rate Bracket					Minimum Tax Rate Bracket	
Category of income	**15%**	**28%**	**31%**	**35%**	**39.6%**	**26%**	**28%**
All dividend income	15	28	31	35	39.6	26	28
Short-term capital gain[1]	15	28	31	35	39.6	26	28
Long-term capital gain[2]	10	20	20	20	20	same as regular tax	
Section 1250 gain[3]	15	25	25	25	25	25	25
Collectible gain	15	28	28	28	28	26	28
Small business stock issued before February 18, 2009 or after December 31, 2011.[4]	7.5	14	14	14	14	18.46[7]	19.88[7]
Empowerment zone small business stock issued before February 18, 2009, or after December 31, 2011	6	11.2	11.2	11.2	11.2	14.768	15.904
Small business stock issued after February 17, 2009, and before September 28, 2010.	3.75	7	7	7	7	11.76	12.88
Five-year gain acquired before 2001	8	20	20	20	20	same as regular tax	
Five-year gain acquired after 2000	8	18	18	18	18	same as regular tax	
Small business stock issued after September 27, 2010, and before January 1, 2012; D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0

Table 3.–Tax Rates Applicable Under Administration Proposal to Certain Categories of Income, 2013 and Thereafter

	Regular Tax Rate Bracket							Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**36%**	**39.6%**	**26%**	**28%**
Qualified dividend income	0	0	15	15	15	20	20	same as regular tax	
Non-qualified dividend income and short-term capital gain[1]	10	15	25	28	33	36	39.6	26	28
Long-term capital gain[2]	0	0	15	15	15	20	20	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	28	26	28
Small business stock issued before February 18, 2009[4]	0	0	12.5	14	14	14	14	13.91	14.98
Empowerment zone small business stock issued before February 18, 2009	0	0	10	11.2	11.2	11.2	11.2	11.592	12.376
Small business stock issued after February 17, 2009	0	0	0	0	0	0	0	0	0
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0	0	0

Notes:

[1] Gain from assets held not more than one year.

[2] Gain from assets held more than one year not included in another category.

[3] Capital gain attributable to depreciation on section 1250 property (i.e., depreciable real estate).

[4] Effective rates after application of 50-percent exclusion for small business stock held more than five years.

[5] Effective rates after application of 60-percent exclusion for small business empowerment zone stock held more than five years.

[6] D.C. Enterprise Zone stock issued after December 31, 1997, and before January 1, 2012, and Renewal Community stock issued after December 31, 2001, and before January 1, 2010. The stock must be held for more than five years.

[7] If the holding period for the stock begins after 2000, the rates are 16.64 percent and 17.92 percent, respectively.

Beyond any difficulties the various rates may create for a taxpayer's calculation of his or her tax liability, opponents of a preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange

treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and IRS positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service.

Furthermore, it is argued that so long as a limitation on deductions of capital loss is retained, some areas of uncertainty and dispute will continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business). Because limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the potential for simplification and consistency may be limited.

Prior Action

The American Recovery and Reinvestment Tax Act of 2009 changed the applicable tax rates for qualified small business stock issued after February 17, 2009, and before January 1, 2011. The Creating Small Business Jobs Act of 2010 provided a 100-percent exclusion for qualified small business stock issued after September 27, 2010, and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the100-percent exclusion to qualified small business stock issued during 2011.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the current rates on qualified dividend income and adjusted net capital gain for two years thru 2012.

PART II − TAX CUTS FOR BUSINESS

A. Eliminate Capital Gains Taxation on Investments in Small Business Stock

Present Law

In general

Individuals may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for more than five years.[78] The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[79] A percentage of the excluded gain is an alternative minimum tax preference;[80] the portion of the gain includible in alternative minimum taxable income ("AMTI") is taxed at a maximum rate of 28 percent under the alternative minimum tax ("AMT").

The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

Special rules for certain stock issued in 2009, 2010, and 2011

For stock issued after February 17, 2009, and before September 28, 2010, the percentage exclusion for qualified small business stock sold by an individual is increased to 75 percent.

As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at maximum effective rates of seven percent under the regular tax[81] and 12.88 percent under the AMT.[82]

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[78] Sec. 1202.

[79] Sec. 1(h).

[80] Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

[81] The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

[82] The 46 percent of gain included in AMTI s taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

For stock issued after September 27, 2010, and before January 1, 2012, the percentage exclusion for qualified small business stock sold by an individual is increased to 100 percent and the minimum tax preference does not apply.

Description of Proposal

Under the proposal the 100-percent exclusion is made permanent. The AMT preference is eliminated. Other current law limitations on exclusion and the requirement that the small business stock be held for five years continue to apply. Additional documentation is required to insure compliance with these limitations and taxpayers are required to report sales on their income tax returns.

Effective date.−The proposal is effective for qualified small business stock acquired after December 31, 2011.

Analysis

For analysis of this proposal, as well as capital gains in general, see Analysis under "Tax Qualified Dividends and Net Long-Term Capital Gains at a 20-Percent Rate for Upper-Income Taxpayers," Part I.G.

Prior Action

The American Recovery and Reinvestment Tax Act of 2009 changed the applicable tax rates for qualified small business stock issued after February 17, 2009, and before January 1, 2011. The Small Business Jobs Act of 2010 provided a 100-percent exclusion for qualified small business stock issued after September 27, 2010, and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the100-percent exclusion to qualified small business stock issued during 2011.

B. Enhance and Make the Research Credit Permanent

Present Law

General rule

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[83] Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.[84]

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

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2011.[85]

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that

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[83] Sec. 41.

[84] Sec. 41(e).

[85] Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[86]

In computing the credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[87] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[88]

Alternative simplified credit

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

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[89] Notwithstanding the limitation for

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

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

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

[89] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt

contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[90] In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.[91] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[92] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[93] Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[94]

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organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

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

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

[92] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

[93] Sec. 280C(c).

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

Description of Proposal

The proposal makes the research credit permanent and increases the rate of the alternative simplified credit from 14 percent to 17 percent.

Effective date.−The proposal is effective for amounts paid or incurred after December 31, 2011.

Analysis

Overview

Technological development is an important component of economic growth. However, although an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm may be cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace may improve overall economic efficiency.[95] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. However, there is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[96] Nevertheless, even if there were agreement that additional subsidies for research are warranted as a general matter, misallocation of research dollars across competing sectors of the economy could diminish economic efficiency. It is difficult to determine whether, at the present levels and allocation of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency.

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[95] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

[96] See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. XCIV, (1992); M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423 (1993); and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield (eds.), *Technology, R&D and the Economy* Washington, D.C.: Brookings Institution Press (1996), pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43. Charles I. Jones and John C. Williams, "Measuring the Social Return to R&D," *Quarterly Journal of Economics*, 113 (November 1998), also conclude that "advanced economies like the United States substantially under invest in R&D" p. 1120.

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little consensus regarding the magnitude of the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should increase research activities beyond what they otherwise would be. However, the present law research credit contains certain complexities and compliance costs.

Scope of research activities in the United States and abroad

In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.7 percent of gross domestic product in 2007.[97] This rate of expenditure on research and development exceeds that of the European Union (1.8 percent) and the average of all countries that are members of the Organisation for Economic Co-operation and Development ("OECD") (2.3 percent), but is less than that of Japan (3.4 percent). In 2007, expenditures on research and development in the United States represented 41.6 percent of all expenditures on research and development undertaken by OECD countries, were 40 percent greater than the total expenditures on research and development undertaken in the European Union, and were approximately two and one half times such expenditures in Japan.[98]

Business expenditures on research and development in the United States have grown at an average real rate of 3.1 percent over the period 1997-2007. This rate of growth has exceeded that of France (1.0 percent), the United Kingdom (2.3 percent), and Italy (2.2 percent), but is less than that of Germany (3.2 percent), Japan (3.8 percent), Canada (3.9 percent), Ireland (6.5 percent), and Spain (9.4 percent).[99]

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[97] Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Scoreboard, 2009*. This data represents outlays by private persons and by governments. The figures reported in this paragraph and Figure 1 do not include the value of tax expenditures, if any. The OECD calculates that the United States spent approximately $369 billion on research and development in 2007. Organisation for Economic Co-operation and Development, *Main Science and Technology Indicators* database, June 2009.

[98] OECD, *Science, Technology and Industry Scoreboard, 2009*. While the OECD attempts to present these data on a standardized basis the cross-country comparisons are not perfect. For example, the United States reporting for research spending generally does not include capital expenditure outlays devoted to research while the reporting of some other countries does include capital expenditures.

[99] OECD, *Science, Technology and Industry Scoreboard, 2009*. The annual real rate of growth of business expenditures on research and development for the period 1997-2007 in the European Union and in all OECD countries was 3.5 percent and 3.8 percent, respectively. All reported growth rates are calculated in terms of U.S. dollars equivalents converted at purchasing power parity.

Government budget expenditures on research and development in the United States have grown at an average real rate of 4.2 percent over the period 2000-2008. This rate of growth exceeds that over similar periods in France (-0.4 percent), Germany (1.2 percent), Italy (2.4 percent), the United Kingdom (2.7 percent), and Japan (2.9 percent), but is less than that of Canada (4.3 percent), Spain (11.9 percent), and Ireland (13.8 percent).[100]

A number of countries, in addition to the United States, provide tax benefits to taxpayers who undertake research activities. The OECD has attempted to quantify the relative value of such tax benefits in different countries by creating an index that measures the total value of tax benefits accorded research activities relative to simply permitting the expensing of all qualifying research expenditures. Table 1, below, reports the value of this index for selected countries. A value of zero would result if the only tax benefit a country offered to research activities was the expensing of all qualifying research expenditures. Negative values reflect tax benefits less generous than expensing. Positive values reflect tax benefits more generous than expensing. For example, in 2008 in the United States qualifying taxpayers could expense research expenditures and, in certain circumstances, claim the research and experimentation tax credit. The resulting index number for the United States is 0.066.[101]

Table 1.–Index Number of Tax Benefits for Research Activities in Selected Countries, 2008

Country	Index Number[1]
Germany	-0.020
United States	0.066
United Kingdom	0.105
Ireland	0.109
Japan	0.116
Italy	0.117

[100] OECD, *Science, Technology and Industry Scoreboard, 2009.* The annual real rate of growth of government budget expenditures on research and development for the period 1998-2008 in the European Union and in all OECD countries was 2.4 percent and 3.8 percent, respectively. All reported growth rates are calculated in terms of U.S. dollars equivalents converted at purchasing power parity.

[101] *OECD Science, Technology and Industry Scoreboard, 2009*. The index is calculated as one minus the so-called "B-index." The B-index is equal to the after-tax cost of an expenditure of one dollar on qualifying research, divided by one minus the taxpayer marginal tax rate. Alternatively, the B-index represents the present value of pre-tax income that is necessary to earn to finance the research activity and earn a positive after-tax profit. In practice, construction of the B-index and the index number reported in Table 1 requires a number of simplifying assumptions. As a consequence, the relative position of the tax benefits of various countries reported in the table is only suggestive.

Country	Index Number[1]
Canada	0.180
Spain	0.349
France	0.425

[1] Index number reported is only that for "large firms." Some countries (notably Canada and the United Kingdom) have additional tax benefits for research activities of "small" firms.

Source: OECD, OECD Science, Technology and Industry Scoreboard, 2009.

Scope of tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit was estimated to be $4.9 billion for fiscal year 2009. The related tax expenditure for expensing of research and development expenditures was estimated to be $3.1 billion for 2009, growing to $6.5 billion for 2013.[102] As noted above, the Federal Government also directly subsidizes research activities. Direct government outlays for research have substantially exceeded the annual estimated value of the tax expenditure provided by either the research and experimentation tax credit or the expensing of research and development expenditures. For example, in fiscal 2008, the National Science Foundation gross outlays for research and related activities were $4.6 billion, the Department of Defense's budget for research, development, test and evaluation was $84.7 billion, the Department of Energy's science gross outlays were $3.9 billion, and the Department of Health and Human Services' budget for the National Institutes of health was $28.9 billion.[103] However, such direct government outlays generally are for directed research on projects selected by the government. The research credit provides a subsidy to any qualified project of an eligible taxpayer with no application to a grant-making agency required. Projects are chosen based on the taxpayer's assessment of future profit potential.

Tables 2 and 3 present data for 2006 on those corporations that claimed the research tax credit by industry and asset size, respectively. Over 17,000 corporations (including both C corporations and S corporations) claimed more than $7.6 billion of research tax credits in 2006.[104] Corporations whose primary activity is manufacturing account for just more than one-

[102] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013* (JCS-1-10), January 11, 2010, p. 29.

[103] Office of Management and Budget, *Appendix*, *Budget of the United States Government, Fiscal Year 2010*, pp. 1141, 293, 295, 297, 413, and 469.

[104] The $7.6 billion figure reported for 2006 is not directly comparable with the Joint Committee on Taxation Staff's $4.8 billion tax expenditure estimate for 2006 (Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005, p. 30). The tax expenditure estimate accounts for the present-law requirement that deductions for research expenditures be reduced by research credits claimed. Also, the $7.6 billion figure does not reflect the actual tax reduction achieved by taxpayers claiming research credits in 2006, as the actual tax reduction will depend upon whether the taxpayer had operating losses, was

half of all corporations claiming a research tax credit. These manufacturers claimed more than 70 percent of all credits. Firms with assets of $50 million or more account for almost 17 percent of all corporations claiming a credit but represent more than 80 percent of the credits claimed. Nevertheless, as Table 3 documents, a large number of small firms are engaged in research and were able to claim the research tax credit. C corporations claimed almost $7.3 billion of these credits and, furthermore, nearly all of this $7.3 billion was the result of the firm's own research. Only $137 million in research credits flowed through to C corporations from ownership interests in partnerships and other pass-through entities.

For comparison, individuals claimed $388 million in research tax credits on their individual income tax returns in 2006. This $388 million includes credits that flowed through to individuals from pass-through entities such as partnerships and S corporations, as well those credits generated by sole proprietorships.

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subject to the alternative minimum tax, and other aspects specific to each taxpayer's situation. In addition, at the time the Joint Committee on Taxation staff made its tax expenditure estimate, the law provided that the research credit would expire after December 31, 2005.

Table 2.–Percentage Distribution of Corporations Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2006

Industry	Percent of Corporations Claiming Credit	Percent of Total R & E Credit
Manufacturing	50.7	71.6
Professional, Scientific, and Technical Services	23.4	10.0
Information	6.6	9.8
Wholesale Trade	8.6	3.5
Finance and Insurance	1.7	1.7
Holding Companies	2.8	1.1
Retail Trade	1.8	0.6
Health Care and Social Services	0.8	0.4
Utilities	0.3	0.4
Administrative and Support and Waste Management and Remediation Services	1.1	0.2
Mining	0.2	0.2
Transportation and Warehousing	0.5	0.1
Construction	0.4	0.1
Agriculture, Forestry, Fishing, and Hunting	0.5	(1)
Real Estate and Rental and Leasing	0.4	(1)
Arts, Entertainment, and Recreation	0.2	(1)
Educational Services	0.1	(1)
Other Services	(2)	(2)
Accommodation and Food Services	(2)	(2)
Wholesale and Retail Trade not Allocable	(2)	(2)
Not Allocable	(2)	(2)

[1] Less than 0.1 percent.
[2] Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Table 3.–Percentage Distribution of Corporations Claiming Research Tax Credit and of Credit Claimed by Corporation Size, 2006

Asset Size ($)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	2.1	0.9
1 to 99,999	5.0	(1)
100,000 to 249,999	1.6	(1)
250,000 to 499,999	4.5	0.1
500,000 to 999,999	9.1	0.3
1,000,000 to 9,999,999	39.9	5.4
10,000,000 to 49,999,999	20.9	12.4
50,000,000 +	16.9	80.7

Notes:
Totals may not add to 100 percent due to rounding.
(1) Less than 0.1 percent.
Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Flat versus incremental tax credits

For a tax credit to be effective in increasing a taxpayer's research expenditures, it is not necessary to provide that credit for all the taxpayer's research expenditures (i.e., a flat credit). By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives to have the largest effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of $105 and Project B will generate cash flow with a present value of $95. Suppose that the research cost of investing in each of these projects is $100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Alternatively, consider the situation where a 10-percent flat credit applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to $90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to $90, this previously neglected project (with a present value of $95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits do not attempt to reward projects that would have been undertaken in any event, but rather to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures. In the example above, if an

incremental credit were properly targeted, the government could spend the same $20 in credit dollars and induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded $80. Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's base amount. Tax credits are provided only for amounts above this base amount.

Because a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures determined to be below their base amount receive no credit.

Fixed base versus moving base credit

Taxpayers effectively have the choice of two different research credit structures for general research expenditures: the regular credit and the alternative simplified credit.[105] The regular credit is a wholly "incremental" credit, while the alternative simplified credit has an incremental feature. In addition, the base is determined differently in each case. The regular credit is a "fixed base" credit. With a fixed base credit, the incremental amount of qualified research expenditures is determined with reference to prior qualified research expenditures incurred over a fixed period of time. The alternative simplified credit is a "moving base" credit. With a moving base credit, the incremental amount of qualified research expenditures for a given year is determined by reference to qualified research expenditures incurred on a rolling basis in one or more prior years. The distinction can be important because, in general, an incremental tax credit with a base amount equal to a moving average of previous years' qualified expenditures is considered to have an effective rate of credit substantially below its statutory rate. On the other hand, an incremental tax credit with a base amount determined as a fixed base generally is considered to have an effective rate of credit equal to its statutory rate.

[105] A taxpayer election into one of these structures is permanent unless revoked by the Secretary. However, historically, permission to revoke an election has routinely been granted by the Secretary, effectively making the choice an annual election.

To see how a moving base creates a reduction in the effective rate of credit, consider the structure of the alternative simplified credit. The base of the credit is equal to 50 percent of the previous three years' average of qualified research expenditures. Assume a taxpayer has been claiming the alternative simplified credit and is considering increasing his qualified research expenditures this year. A $1 increase in qualified expenditures in the current year will earn the taxpayer 14 cents in credit in the current year but it will also increase the taxpayer's base amount by 16.7 cents (50 percent of $1 divided by three) in each of the next three years. If the taxpayer returns to his previous level of research funding over the subsequent three years, the taxpayer will receive two and one-third cents less in credit than he otherwise would have. Assuming a nominal discount rate of 10 percent, the present value of the one year of credit increased by 14 cents followed by three years of credits reduced by two and one-third cents is equal to 8.19 cents. That is, the effective credit rate on a $1 dollar increase in qualified expenditures is 8.19 percent.

An additional feature of the moving average base calculation of the alternative simplified credit is that it is not always an incremental credit. If the taxpayer never alters his or her research expenditures, the alternative simplified credit is the equivalent of a flat rate credit with an effective credit value equal to one half of the statutory credit rate. Assume a taxpayer spends $100 per year annually on qualified research expenses. This taxpayer will have an annual base amount of $50, with the result that the taxpayer will have $50 of credit eligible expenditures on which the taxpayer may claim $7 of tax credit (14 percent of $50). For this taxpayer, the 14-percent credit above the defined moving average base amount is equivalent to a seven-percent credit on the taxpayer's $100 of annual qualifying research expenditures.

The moving average base calculation of the alternative simplified credit also can permit taxpayers to claim a research credit while they decrease their research expenditures. Assume as before that the taxpayer has spent $100 annually on qualified research expenses, but decides to reduce research expenses in the next year to $75 and in the subsequent year to $50, after which the taxpayer plans to maintain research expenditures at $50 per year. In the year of the first reduction, the taxpayer would have $25 of qualifying expenditures (the taxpayer's prior three-year average base is $100) and could claim a credit of $3.50 (14 percent of the $75 current year expenditure less half of three year average base). In the subsequent four years, the taxpayer could claim a credit of $0.58, $1.75, $2.92, and $3.50.[106] Of course, it is also the case that a taxpayer may claim a research credit as he or she reduces research expenditures under a fixed base credit as long as the taxpayer's level of qualifying expenditures is greater than the fixed base.

Some have also observed that a moving base credit can create incentives for taxpayers to "cycle" or bunch their qualified research expenditures. For example, assume a taxpayer who is claiming the alternative simplified credit has had qualified research expenditures of $100 per year for the past three years and is planning on maintaining qualified research expenditures at $100 per year for the next three years. The taxpayer's base would be $50 for each of the next three years and the taxpayer could claim $7 of credit per year. If, however, the taxpayer could

[106] In the subsequent four years, 50 percent of the prior three years' expenditures equals $45.83, $37.50, $29.17, and $25.00. In each year, the taxpayer's expenditure of $50 exceeds 50 percent of the prior three years' expenditures.

bunch expenditures so that the taxpayer incurred only $50 of qualified research next year, followed by $150 in the second year and $100 in the third, the taxpayer could claim no credit next year but $15.17 in the second year and $7 dollars in the third. While the example demonstrates a benefit to cycling, as the majority of qualified research expenditures consist of salaries to scientists, engineers, and other skilled labor, the potential for cycling most likely would be limited in practice.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of price elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[107] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[108]

While all published studies report that the research credit induced increases in research spending, early evidence generally indicated that the price elasticity for research is substantially less than one. For example, one early survey of the literature reached the following conclusion:

In summary, most of the models have estimated long-run price elasticities of demand for research and development on the order of -0.2 and -0.5. However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[109]

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[107] For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity−such as research scientists and engineers−is in short supply.

[108] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise−so called marginal research expenditures−need be subject to the credit to have a positive incentive effect.

[109] Charles River Associates, "An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive" (final report prepared for the National Science Foundation) (February 1985), p. G-14. The negative coefficient in the text reflects that a decrease in price results in an increase in research expenditures. Often, such elasticities are reported without the negative coefficient, it being understood that there is an inverse relationship between changes in the "price" of research and changes in research expenditures.

In a 1983 study, the Treasury Department used an elasticity of 0.92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. See Department of the Treasury, "The Impact of Section 861-8 Regulation on Research and Development," p. 23. As stated in the text, although there is uncertainty, most analysts

If it took time for taxpayers to learn about the credit and what sort of expenditures qualified, taxpayers may have only gradually adjusted their behavior. Such a learning curve might explain a modest measured behavioral effect. A more recent survey of the literature on the effect of the tax credit suggests a stronger behavioral response, although most analysts agree that there is substantial uncertainty in these estimates.

> [W]ork using US firm-level data all reaches the same conclusion: the tax price elasticity of total research and development spending during the 1980s is on the order of unity, maybe higher. … Thus there is little doubt about the story that the firm-level publicly reported research and development data tell: the research tax credit produces roughly a dollar-for-dollar increase in reported research and development spending on the margin.[110]

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believe the elasticity is considerably smaller. For example, the General Accounting Office (now called the Government Accountability Office) summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." See *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114) (September 1989), p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3," in Edwin Mansfield, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, vol. 76, no. 2 (May 1986), p. 191.

[110] Bronwyn Hall and John Van Reenen, "How Effective Are Fiscal Incentives for R&D? A Review of the Evidence," *Research Policy*, vol. 29, 2000, p. 462. This survey reports that more recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to appreciate fully the incentive structure of the revised credit. See Bronwyn H. Hall, "R&D Tax Policy During the 1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 7 Cambridge: The MIT Press (1993), pp. 1-35. Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, the estimated elasticities fell by half after including an additional 76 firms that had initially been excluded because they had been involved in merger activity. See James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s" in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, Chicago: University of Chicago Press (1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, "R&D Tax Incentives and Manufacturing-Sector R&D Expenditures," in James M. Poterba, (ed.), *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment,* Washington, D.C.: National Academy Press (1997). While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, "Does Government R&D Policy Mainly Benefit Scientists and Engineers?," *American Economic Review*, vol. 88 (May 1998), pp. 298-302.

However, this survey notes that most of this evidence is not drawn directly from tax data. For example, effective marginal tax credit rates are inferred from publicly reported financial data and may not reflect limitations imposed by operating losses or the AMT. The study notes that because most studies rely on "reported research expenditures" that a "relabeling problem" may exist whereby a preferential tax treatment for an activity gives firms an incentive to classify expenditures as qualifying expenditures. If this occurs, reported expenditures increase in response to the tax incentive by more than the underlying real economic activity. Thus, reported estimates may overestimate the true response of research spending to the tax credit.[111]

Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

Other policy issues related to the research and experimentation credit

Design features

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below the base amount, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the AMT or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[112]

Effective rate of credit

Except for energy research, firms with research expenditures substantially in excess of their base amount are subject to the 50-percent base amount limitation. In general, although

[111] Hall and Van Reenen, "How Effective Are Fiscal Incentives for R&D? A Review of the Evidence," p. 463.

[112] As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

these firms received the largest amount of credit when measured as a percentage of their total qualified research expenses, their marginal effective rate of credit was exactly one half of the statutory credit rate of 20 percent (i.e., firms subject to the base limitation effectively are governed by a 10-percent credit rate).

Although the statutory rate of the research credit is 20 percent, it is likely that the average effective marginal rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms are subject to various limitations discussed above yield estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, i.e., between 12 and 15 percent.[113]

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will drift from the firm's actual current qualified research expenditures. Therefore, if the research credit were made permanent, increasingly over time there would be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms would receive no credit and have no reasonable prospect of ever receiving a credit, while other firms would receive large credits (despite the 50-percent base amount limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average effective marginal rate of credit would decline while the revenue cost to the Federal government increased.

Sector-specific subsidies

As explained above, because costly scientific and technological advances made by one firm may often be cheaply copied by its competitors, research is one of the areas where there is a consensus among economists that government intervention in the marketplace, such as the subsidy of the research tax credit, can improve overall economic efficiency. This rationale suggests that the problem of a socially inadequate amount of research is not more likely in some industries than in other industries, but rather it is an economy-wide problem. The basic economic rationale argues that a subsidy to reduce the cost of research should be equally applied across all sectors. As described above, the Energy Policy Act of 2005 provided that energy-related research receive a greater tax subsidy than other research. Some argue that it makes the tax subsidy to research inefficient by biasing the choice of research projects. They argue that an energy-related research project could be funded by the taxpayer in lieu of some other project that would offer a higher rate of return absent the more favorable tax credit for the energy-related project. Proponents of the differential treatment for energy-related research argue that broader policy concerns such as promoting energy independence justify creating a bias in favor of energy related research.

Definitional issues

A recent Government Accountability Office ("GAO") study highlighted several definitional issues affecting the administrability of the research credit, including the definition of

[113] For a more complete discussion of this point, see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 65-66.

credit-eligible supplies and internal use software.[114] In 1986, Congress narrowed the definition of qualified research for purposes of claiming the credit by, in part, generally excluding from credit-eligible research expenditures for the development of computer software for the taxpayer's own internal use. Specifically, research with respect to computer software that is developed by or for the benefit of the taxpayer primarily for the taxpayer's own internal use is eligible for the research credit only if the software is used in (1) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, or (2) a production process that meets the requirements for the credit. Any other research activities with respect to internal-use software are not eligible for the credit except to the extent provided in regulations. Congress intended that regulations would make the costs of new or improved internal-use software credit eligible only if, in addition to satisfying all other requirements for the credit, the taxpayer establishes that (1) the software is innovative (e.g., the software results in a reduction in costs, or improvement in speed, that is substantial and economically significant), (2) the software development involves significant economic risk (e.g., the taxpayer commits substantial resources to the development and there is substantial uncertainty because of technical risk that such resources would be recovered with a reasonable period), and (3) the software is not commercially available for use by the taxpayer (e.g., the software cannot be purchased, leased, or licensed and used for the intended purpose).

In the Conference Report to the Tax Relief Extension Act of 1999, Congress noted "the rapid pace of technological advance, especially in service-related industries," and suggested that software research that otherwise satisfies the requirements of section 41 that is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.[115]

Treasury's most recent attempt at guidance with respect internal-use software was in a 2004 Advance Notice of Proposed Rulemaking in which Treasury noted that "the Treasury Department and the IRS are concerned about the difficulty of effecting Congressional intent behind the exclusion for internal-use software with respect to computer software being developed today. Despite Congress' broad grant of regulatory authority in section 41(d)(4)(E), the Treasury Department and the IRS believe that this authority may not be broad enough to resolve those difficulties."[116]

The uncertainty as to the availability of the research credit for the development of internal-use software may shift investment away from such research to other research which it is clear is eligible for the credit. Such a shift may not represent the efficient allocation of research funding.

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[114] Government Accountability Office, *The Research Tax Credit's Design and Administration Can Be Improved*, November 2009, pp. 69-79. Other issues included the definition of commercial production and the general qualification tests.

[115] H.R. Conf. Rep. No. 106-478, p. 132 (1999).

[116] 69 Fed. Reg. 43.

A second definitional issue relates to credit eligible supplies expenditures. A recent court case concluded that supplies expenditures incurred with respect to property held for sale by the taxpayer were credit eligible even though identical costs with respect to property used in the taxpayer's trade or business were ineligible.[117] Present law generally treats as credit eligible supplies expenditures tangible property other than land, improvements to land, or property of a character subject to the allowance for depreciation. Taxpayers and the IRS disagree as to whether the cost of supplies used in constructing tangible property such as molds and prototypes, where such items are held for sale by the taxpayer, are eligible for the research credit.[118]

While allowing credits for a relatively expansive definition of research supplies might increase total credits claimed substantially, this does not by itself make the credit more or less efficient. What determines the efficiency of research subsidies is, as discussed above, the extent to which such subsidies cause new research that generates benefits for other firms or individuals. That is, for purposes of economic efficiency what matters is just how much any induced research benefits others, not the ratio of such "external" benefits to the benefit to the firm: it is entirely possible for research subsidies to improve economic efficiency even if the vast majority of the benefit of the research flows to the researching firm itself.

Thus, if defining "supplies" more expansively causes additional research that other firms may copy easily, then the resulting increase in tax expenditures may improve economic efficiency if the benefit derived by other firms is sufficiently high. On the other hand, opponents may believe that relative to other credit-eligible expenditures, supplies expenditures are either less likely to benefit other firms, or that any such external benefits are particularly mild, or perhaps less likely to induce more research. Alternately, they might argue that in principle supplies expenditures improve efficiency, but that "supplies" is improperly defined so as to allow the inclusion of too many tangible goods with benefits accruing solely to the researching firm. If so, it might be argued, that modifying the credit to limit the definition of supplies (or possibly disallowing the credit for supplies expenditures entirely) and focusing the credit on other forms

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[117] *T.G. Missouri Corp. v. Commissioner*, 133 TC 278 (2009). This case involved a taxpayer who developed and used production molds to manufacture auto parts. The taxpayer paid third-party toolmakers to build the production molds and then incurred additional design and engineering costs to modify the molds so that they could be used to produce the desired component parts. Some of the molds were then sold to the taxpayer's customers while others were not. In both cases, the taxpayer retained physical possession of the molds and used them to produce the parts. The findings of the Tax Court were that the molds sold to the taxpayer's customers were not depreciable assets (as required by section 41(b)(2)(C)(ii)) because they were held for resale. Thus, the costs associated with the molds were properly includable as supply costs for purposes of calculating the research credit (whereas costs associated with the molds that were not sold received the opposite result). See also *Trinity Industries v. United States*, 691 F. Supp. 2d 688 (DC TX 2010).

[118] Under present law, taxpayers also may be able to claim the research credit for what might otherwise be relatively routine supply costs. For example, consider a hypothetical cattle-raising firm trying to determine whether a new genetically-modified feed improves the size and health of its cows. One straightforward way of testing the new feed would be to give the new feed to a random sample of the firm's existing cattle and compare the results relative to the rest of the herd. In principle, such a firm might be able to claim a credit for all of the feed, including the regular feed given to the "control group" (i.e., all of the rest of the cows), even though the firm obviously would have fed all of the animals whether conducting this experiment or not.

of research or other expenditures could improve economic efficiency and any social benefits of research without requiring an increase in tax expenditures.

Administrative complexity

Administrative and compliance burdens result from the research tax credit. The GAO has testified that the research tax credit is difficult for the IRS to administer.[119] According to the GAO, the IRS reports that it is required to make difficult technical judgments in audits concerning whether research is directed to produce truly innovative products or processes. Although the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.[120] An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

> Tax incentives such as the R&D tax credit … typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. … [I]s what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.[121]

In addition to compliance challenges, with the addition of the alternative simplified credit, taxpayers now have multiple research credit structures to choose from, including the energy research credit and the university basic research credit. The presence of multiple research credit options creates increased complexity by requiring taxpayers to make multiple calculations to determine which credit structure will result in the most favorable tax treatment.

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[119] See also, Government Accountability Office, *The Research Tax Credit's Design and Administration Can Be Improved*, November 2009, pp. 87-98, noting that common controversy issues include the use of a cost center versus project accounting approach to tracking research expenditures, sufficiency of base period documentation, and sampling issues.

[120] Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate, April 3, 1995.

[121] David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, vol. 50 (September 1997), pp. 487-493.

Prior Action

The President's budget proposals for fiscal years 2003 through 2006 contained proposals to make the research credit permanent. The President's budget proposal for fiscal year 2007 contained a similar proposal, but did not extend or make permanent the energy research credit. The President's budget proposals for fiscal years 2008 through 2011 contained proposals to make the research credit permanent.

C. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project

Present Law

Present law provides a 30-percent credit for investment in qualified property used in a qualifying advanced energy manufacturing project. A qualifying advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for the production of: (1) property designed to be used to produce energy from the sun, wind, or geothermal deposits (within the meaning of section 613(e)(2)), or other renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) electric grids to support the transmission of intermittent sources of renewable energy, including storage of such energy; (4) property designed to capture and sequester carbon dioxide; (5) property designed to refine or blend renewable fuels (but not fossil fuels) or to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies); (6) new qualified plug-in electric drive motor vehicles, qualified plug-in electric vehicles, or components which are designed specifically for use with such vehicles, including electric motors, generators, and power control units; or (7) other advanced energy property designed to reduce greenhouse gas emissions as may be determined by the Secretary. A qualifying advanced energy project does not include any part of a project for the production of any property for use in the refining or blending of any transportation fuel other than renewable fuels.

Qualified property must be depreciable (or amortizable) property used in a qualifying advanced energy project. Only tangible personal property and other tangible property (not including a building or its structural components) are credit-eligible. The basis of qualified property must be reduced by the amount of credit received. No credit is allowed for any qualified investment that is allowed a credit under sections 48, 48A, or 48B.

Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. The Secretary of Treasury has established a certification program for this purpose, and may allocate up to $2.3 billion in credits.

Certifications are issued using a competitive bidding process. Current Treasury guidance requires taxpayers to apply for certification with respect to their entire qualified investment in a project.

In selecting projects, the Secretary may consider only those projects with a reasonable expectation of commercial viability. In addition, the Secretary must consider other selection criteria, including which projects: (1) will provide the greatest domestic job creation; (2) will provide the greatest net impact in avoiding or reducing air pollutants or anthropogenic emissions of greenhouse gases; (3) have the greatest potential for technological innovation and commercial deployment; (4) have the lowest levelized cost of generated or stored energy, or of measured reduction in energy consumption or greenhouse gas emission; and (5) have the shortest project time from certification to completion.

Each project application must be submitted during the two-year period beginning on the date the certification program was established. An applicant for certification has one year from the date the Secretary accepts the application to provide the Secretary with evidence that the requirements for certification have been met. Upon certification, the applicant has three years from the date of issuance of the certification to place the project in service. Not later than four years after February 17, 2009 (the date of enactment of the American Recovery and Reinvestment Act of 2009), the Secretary is required to review the credit allocations and redistribute any credits that were not used either because of a revoked certification or because of an insufficient quantity of credit applications.

Description of Proposal

The proposal authorizes an additional $5 billion of credits for investments in eligible property used in a qualifying advanced energy project. Under the proposal taxpayers may apply for a credit with respect to only part of their qualified investment. This second element of the proposal will be accomplished through administrative guidance and does not require legislative action. If a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government will be taken into account in determining whether to allocate credits to the project.

Effective date.−The proposal is effective on the date of enactment.

Analysis

The proposal expands the amount of investment tax credits that may be allocated for investment in manufacturing facilities that produce specified products, many of which are also subsidized on the consumption side of the market via tax credits for their purchase. The manufacturing projects that may qualify generally have in common the feature that they produce goods whose use would displace the consumption of fossil fuels.

Economists are generally skeptical of government interventions in markets that alter prices from those that would otherwise prevail in a free market, but most would agree that a valid economic rationale for government intervention in certain markets (including many aspects of energy markets) can exist when there are "externalities" in the consumption or production of certain goods that lead to "market failures," wherein either too little or too much of certain economic activity occurs relative to what is the socially optimal level of activity.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are various ways the government could intervene in markets to limit pollution to more economically efficient levels. One approach is to control pollution directly through regulation of polluters, such as by requiring coal burning electric utilities to install scrubbers to limit their emissions of various pollutants. Other more market oriented approaches to achieving socially optimal levels of pollution control are also possible, such as by setting a tax on the polluting activity that is equal to the social cost of the pollution.

In the case of a positive externality, the appropriate economic policy would be to impose a negative tax (i.e., a subsidy) on the consumption or production that produces the positive

externality, such that the socially optimal level of consumption or production results. An example where such a positive externality is thought to exist is in basic scientific research, as the social payoffs to such research are not fully captured by private parties that undertake, and incur the cost of, such research. As a result, a socially sub-optimal level of such research is undertaken. The provision of a subsidy for such research can correct this market inefficiency and lead to socially optimal levels of research.

It could be argued that the manufacturing credit is designed to correct inefficiently low investment in these manufacturing facilities that stems from the facilities producing positive externalities that are not captured in private investment decision making. There are problems with this argument however. There is no clear evidence that positive externalities exist from the domestic production of (a separate notion from the domestic use of) these favored items relative to production of other goods not so favored. In the absence of such externalities, government intervention that distorts investment via subsidies will lead to an inefficient and less productive allocation of resources in the society as a whole.

To the extent that positive externalities exist from the domestic use of the favored production items, the existing subsidy mechanism for the purchase of these goods should be sufficient to address any positive externality related to the use of these goods. Even in this case, economists do not generally argue that consuming wind energy, or driving an electric car, produces positive externalities and thus merits subsidy. Rather, it is thought that subsidizing these activities will divert consumption from other, less desirable consumption of fossil fuels that produce pollution and other negative externalities. However, economists generally agree that the most efficient means of addressing pollution would be a direct tax on the creation of the pollution, rather than an indirect approach that provides targeted tax credits for certain technologies.

The allocation of a fixed amount of tax credits for a given activity can be criticized as leading to unfair tax results. In general, Federal tax credits are available to all taxpayers who meet the statutory eligibility requirements, and are not limited in the aggregate. A tax system that provides only a fixed amount of credits in the aggregate can lead to a situation where two taxpayers of similar means face different tax liabilities, if one has been granted an allocation of credits and the other not. While other Federal disbursements are similarly limited, many have noted that these allocated tax credits are in essence grant programs, and have questioned whether such programs should be run through the tax code, rather than funded directly by grants made under the auspices of other Federal departments.

When there is a limited amount of credit to allocate, providing a fixed percentage credit for the entirety of a qualifying project is not the most cost effective way for the Federal government to utilize the tax code to stimulate desirable manufacturing projects. As the Treasury Department notes in its explanation of the Administration's revenue proposal, the original $2.3 billion credit allocation funded less than one-third of technically acceptable applications. The fact that the program was oversubscribed at the 30 percent credit suggests that the credit was too generous, and that the credit rate could have been lowered while funding more projects on the same budget. Ideally, to efficiently utilize a fixed amount of credit, the government would operate some form of auction whereby applicants bid on the credit rate they would need in order to go forward with a project, and the lowest bidders would obtain the credit

until the $2.3 billion were allocated. This is analogous to how the Treasury Department auctions its securities−it sets a borrowing target and elicits bids in order to obtain the lowest borrowing rate that the market will accept. The allocated credit approach is analogous to a hypothetical, and inefficient, security auction in which the Treasury Department announces it plans to borrow a fixed amount of money at a high interest rate, finds its offer oversubscribed, and then chooses to borrow from the lucky few. This would be an expensive way for the government to borrow.

The Administration proposal notes that guidance for applying for the credit will be revised to no longer require that an applicant apply for the credit with respect to their entire qualified investment, and states that "if a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government will be taken into account in determining whether to allocate credits to the project." This approach will yield efficiencies similar to the auction concept outlined above, as applicants will now in general have the incentive only to bid for as much credit as they need to make their project economically viable, lest they bid for too high an allocation and lose out to a competitor, thus getting no allocation.

Prior Action

This proposal was included in the President's fiscal year 2011 budget.

D. Provide Tax Credit for Energy Efficient Commercial Building Property Expenditures in Lieu of Existing Tax Deduction

Present Law

In general

Code section 179D provides an election under which a taxpayer may take an immediate deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures are defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual.

The Secretary is granted authority to prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems.[122] Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is allowed under this section, the basis of the property shall be reduced by the amount of the deduction.

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[122] See IRS Notices 2006-52 and 2008-40.

The deduction is effective for property placed in service prior to January 1, 2014.

Partial allowance of deduction

In the case of a building that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.60 per square foot for each separate system.

Interim rules for lighting systems

In general, in the case of system-specific partial deductions, no deduction is allowed until the Secretary establishes system-specific targets.[123] However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions under the interim rule.

Corporate earnings and profits effect

Earnings and profits are the measure of corporate economic income that, if distributed to shareholders, is generally taxed to them as a dividend (rather than as a return of their corporate stock basis or as capital gain in excess of basis).[124] Although earnings and profits generally are

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[123] IRS Notice 2008-40 has set a target of a 10-percent reduction in total energy and power costs with respect to the building envelope, and 20 percent each with respect to the interior lighting system and the heating, cooling, ventilation and hot water systems.

[124] Corporate distributions to shareholders are generally treated as a dividend to the extent of current or accumulated earnings and profits. Distributions in excess of that amount first reduce a shareholder's stock basis and thereafter are treated as capital gain with respect to the stock. Sec. 301

If a distribution is made in exchange for a shareholder's stock, as in a corporate stock redemption, and the redemption reduces the shareholder's interest in the corporation by a sufficient amount so that it is not considered essentially equivalent to a dividend, the shareholder is treated as having sold the stock rather than as having received a dividend. Sec. 302.

the same as taxable income in a current year, this is not always the case. Special rules for certain types of corporate deductions and income require earnings and profits to be reduced or increased over a different period than the period in which the corporation recognizes the deductions or income for purposes of computing its income tax.[125]

If a corporation makes an election under section 179D to deduct expenditures immediately, the full amount of the deduction does not reduce earnings and profits immediately. Instead, the expenditures that were deducted reduce corporate earnings and profits ratably over a 5-year period.[126] Thus, in the year of the expenditure, corporate taxable income is reduced by 100 percent of the expenditure while earnings and profits of a regular C corporation[127] is reduced by only 20 percent of the expenditure. In each of the following 4 years, earnings and profits will be reduced by 20 percent of the expenditure but taxable income will not be reduced at all since the entire deduction was taken in the year of the expenditure. A special earnings and profits rule for the following four years applies to REITs, as discussed below.

Real Estate Investment Trusts

In general

A Real Estate Investment Trust ("REIT") is a U.S. entity that would otherwise be taxed in all respects as a regular C corporation but that qualifies and elects to be taxed under a special modified corporate regime. This regime includes many aspects of subchapter C rules, but modifies the rules to create a mechanism that allows the REIT to deduct dividends paid to its shareholders.

In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT taxable income (other than net capital gain) must be distributed as a dividend during the REIT taxable year (or treated as distributed then);[128] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. A REIT must have at least 100 shareholders and may not be closely held by individual shareholders.[129] Other requirements also apply.[130]

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[125] See, e.g., secs. 312(k) and 312(n).

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

[127] The term "regular" C corporation refers to a corporation that is subject to the rules on subchapter C of the Code without the modifications of those rules applicable to REITs (and to regulated investment companies).

[128] See sec. 858. Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, additional distribution requirements must be met in order to avoid an excise tax under section 4981.

[129] No more than 50 percent of REIT's stock may be held by five or fewer individuals (determined using specified attribution rules). There is no comparable rule restricting ownership by corporate shareholders or by various tax exempt organizations.

[130] Secs. 856 and 857.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[131] Although a REIT is not required to distribute more than the 90 percent of its income described above in order to retain REIT status, it will be taxed at ordinary corporate rates on amounts not distributed. Section 4981 also imposes an additional 4 percent excise tax to the extent a REIT does not distribute at least 85 percent of REIT ordinary income (as defined) and 95 percent of REIT capital gain net income within a calendar year period.

Earnings and profits and treatment of REIT and REIT shareholders

REIT shareholders who receive distributions from the REIT are treated as receiving a REIT dividend[132] to the extent the REIT has either current or accumulated earnings and profits.[133] Distributions with respect to REIT stock that are in excess of such earnings and profits of the REIT are treated as a return of shareholders' capital (reducing the shareholders' bases in their REIT stock) and as capital gain of the shareholders with respect to the REIT stock, to the extent they exceed a shareholder's stock basis in the REIT.[134]

A REIT may deduct a distribution to shareholders from its taxable income, and can meet the REIT qualification requirement that it distribute as dividends at least 90 percent of its taxable income (other than net capital gain), only to the extent of distributions that are made out of the earnings and profits of the REIT.[135] As noted above, earnings and profits (deemed to be a measure of the economic income of a corporation that can support a taxable dividend to shareholders) are generally computed for corporations (including REITs) under the rules of section 312 and can differ from taxable income. For example, under section 312(k), certain accelerated depreciation deductions (including section 179D deductions) are allowed to be taken in earlier years for purposes of computing a corporation's taxable income than for purposes of computing corporate earnings and profits, with the result that current earnings and profits are greater than taxable income in the earlier years, but are less than taxable income in later years.

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[131] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[132] REIT dividends are not qualified dividends eligible for the special dividend rate under section 1(h)(11) except to the extent they are from income subject to tax at the REIT level, or are attributable to qualified dividend income received by the REIT, and are so designated by the REIT as qualified dividends. Sec. 857(c). Other REIT dividends are treated as ordinary taxable income to the shareholder, except to the extent they are designated as "capital gain" dividends from net capital gain of the REIT.

[133] Sec. 301.

[134] Sec. 301.

[135] Secs. 857(a)(1), 857(b) and 561.

A special rule for REITs in section 857(d) provides that current REIT earnings and profits will not be reduced by any amount that does not reduce REIT taxable income for the current year.[136] This rule assures that a REIT will always be treated as having enough earnings and profits to make the necessary distributions of 90 percent of taxable income other than net capital gain, and to avoid imposition of any excise tax under section 4981. However, this rule also causes a REIT that elects to accelerate deductions under section 179D[137] to have a greater amount of earnings and profits in each of the four years following the investment than would be the case for a regular C corporation.

A REIT that elected the accelerated section 179D deduction would benefit from that election in that the REIT would be able to retain more cash flow in the first year of the investment, because the REIT would not be required to make a distribution to shareholders in that year to the extent the REIT's taxable income would be reduced under the election. The shareholders also could benefit from the immediate 179D deduction to the extent the value of their REIT stock, if sold, would reflect the value of the untaxed retained amounts. Like the shareholders of any C corporation, the shareholders are not able to receive an immediate distribution from the REIT in the year of the investment that is treated as a return of capital to the full extent of the tax deduction at the REIT level. Rather, the distribution would be a taxable dividend to the extent of the REIT earnings and profits, which have been reduced only by 20 percent of the investment. Unlike the shareholders of a regular C corporation, however, later distributions of REIT taxable income will again be treated as dividends to the shareholders, even though earnings and profits normally would have been reduced below taxable income in later years under general corporate rules of section 312(k). This result occurs because of the special REIT rule of section 857(d)(1) that allows a REIT to have enough current earnings and profits to distribute all of its taxable income in a year.

A REIT that retained the extra cash flow from the 179D deduction in the year of the investment, and that made distributions only as required with respect to its taxable income in later years, would not experience the effect of the "additional" dividend treatment to its shareholders. However, a REIT that desired to make steady annual distributions to shareholders and not retain the non-taxed income in the first year of a 179D investment could cause its shareholders to be treated as receiving more dividend income in the aggregate than would be the case otherwise. Such a REIT might not elect to take the special 179D deduction at all.[138]

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[136] Sec. 857(d).

[137] The section 179D election is not the only rule that can have this effect for a REIT. The temporary election to amortize certain leasehold improvements over 15 years has a similar effect. Sec. 168(k) and sec. 312(k)(3)(A). As another example, depreciation of residential buildings is generally taken over 27.5 years, and of commercial buildings over 39 years for tax purposes, but both are depreciated over 40 years for earnings and profits purposes. Sec. 168(c) and sec. 312(k)(3).

[138] If no election under section 179D were made, the property would be depreciated under the generally applicable depreciation rules, and no special rule would apply that causes earnings and profits to differ from taxable income.

Investment Tax Credits and REITs

The rule for computing the amount of any REIT investment tax credit (including any energy credit) reduces the allowable credit to be proportionate to REIT taxable income, after taking into account the REIT's deduction for dividends paid. This rule limits the benefit of the credit to the proportion that the investing REIT itself uses to reduce its own retained taxable income. The rule operates by reducing the REIT's "qualified investment" to an amount equal to the total investment, multiplied by the ratio of the REIT's actual taxable income (after its deduction for dividends paid) to its taxable income (before its deduction for dividends paid).[139] Because REITs are generally required to distribute 90 percent of taxable income (other than net capital gains), this required reduction of the maximum credit computation generally reduces the credit[140] amount to no more than 10 percent[141] of the amount otherwise allowed to any taxable entity that is not required or permitted to distribute to shareholders, and thus deduct, its taxable income. Tax credits reduce taxable income but do not reduce earnings and profits of a REIT.

Description of Proposal

The proposal would replace the existing deduction for energy efficient commercial building property with a tax credit equal to the cost of property that is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 20 percent or more in comparison to a reference building which meets the minimum requirements of ASHR2AE/IESNA Standard 90.1-2004, as in effect on the date of enactment. The credit with respect to a building would be limited to $0.60 per square foot in the case of energy efficient commercial building property designed to reduce the total annual energy and power costs by at least 20 percent but less than 30 percent, to $0.90 per square foot for qualifying property designed to reduce the total annual energy and power costs by at least 30 percent but less than 50 percent, and to $1.80 per square foot for qualifying property designed to reduce the total annual energy and power costs by 50 percent or more. In addition, the proposal would treat property as meeting the 20-, 30-, and 50-percent energy savings requirement if specified prescriptive standards are satisfied. Prescriptive standards would be based on building types (as specified by Standard 90.1-2004) and climate zones (as specified by Standard 90.1-2004).

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[139] Sec. 50(d)(1), incorporating sec. 46(e)(1)(B) as in effect on the day before the Revenue Reconciliation Act of 1990. The same rule also applies to regulated investment companies (RICs) with respect to any investment tax credit that might apply with respect to their investments. A different rule, also cutting back on the benefit of the credit, applies in the case of certain banks and other institutions eligible for the reserve method of deducting bad debts under section 593.

[140] Moreover, even this reduced tax credit would have been obtained only by subjecting a portion of the REIT's income (to the extent not offset by the credit) to a corporate level of tax as well as any shareholder level tax.

[141] If the REIT distributed a greater amount of its income, whether to avoid the imposition of the 4-percent section 4981 tax or simply to satisfy shareholder desire for greater distributions, the benefit of the credit would be further reduced.

Special rules would be provided that would allow the credit to benefit a REIT or its shareholders.

The tax credit would be available for property placed in service during calendar year 2012.

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

The proposal alters the eligibility criteria for the tax benefit, and changes the delivery mechanism of the tax benefit by converting it to a credit from a deduction. Because a credit reduces tax liability dollar for dollar, while a deduction of the same dollar amount reduces tax liability by the deduction amount times the taxpayer's marginal tax rate, credits are significantly more valuable than deductions. At the top marginal tax rate of 35 percent, a dollar of deductions has its maximum value of 35 cents.

Because present law gives a deduction of $1.80 per square foot for a building that meets the 50 percent standard, while the proposal gives a credit of $1.80 per square foot for a building that meets the 50 percent standard, the proposal is generally about three times as valuable as present law for a building that meets the 50 percent standard, and thus provides a greater incentive to build these very energy-efficient buildings. The proposal also provides a smaller incentive for construction of buildings that are between 20 and 50 percent more efficient than the reference building, thus encouraging construction of energy efficient buildings even if they don't meet the highest efficiency standard. While under present law a building may qualify for a partial deduction based on one of the separate building systems qualifying as discussed above, the proposal effectively relaxes these partial qualification rules. For example, under present law, a building may qualify for a partial sixty cent per square foot deduction based on the HVAC system only if the HVAC system *alone* reduced the total energy consumption of the three separate building systems combined by 20 percent. Under the proposal, if the HVAC system and the building envelope jointly reduced the total energy consumption of the three separate building systems combined by 20 percent, the building would qualify for the reduced credit of 60 cents per square foot.

In certain respects, the proposal possibly constrains some eligible claimants of the deduction under present law as a result of the changes to the rules for separate systems qualifying. In the case of lighting, the interim rules that allow lighting to qualify for a partial deduction of 30 to 60 cents per square foot if lighting power densities are reduced by 25 to 40 percent would no longer apply. To the extent that these lighting power density reductions do not reduce the whole building system energy usage by at least 20 percent, it may be more difficult for certain lighting retrofits to qualify for the credit as compared to the deduction of current law. On the other hand, to the extent that the building already may have an HVAC system or building envelope more efficient than the reference standard, a lighting retrofit that wouldn't qualify for the present law deduction could, in combination with the efficiencies of the existing building envelope and HVAC, enable the building to qualify for a tax credit of 60 cents or more per square foot.

The reference building standard is changed by the proposal from the ASHRAE/IESNA Standard 90.1-2001 (as in effect on April 2, 2003) to the ASHRAE/IESNA Standard 90.1-2004. It is possible that this change in the reference standard alters the difficulty of constructing a building that is 50 percent more efficient than the standard.

The as yet unspecified rule that would permit real estate investment trusts or their shareholders to benefit from the deduction would expand the universe of buildings that could potentially claim the credit as compared to the deduction. Because the intent of the provision is to encourage energy efficiency in building construction, there is a strong case, as a matter of economic efficiency, for assuring that any new construction is eligible for the tax benefit if the building meets the requisite criteria. In crafting such a rule for REITs, however, consideration should be given to whether the purpose of the credit is deemed to be to allow an investing REIT to retain more cash flow to make other investments (as occurs with a regular C corporation), and as is permitted only to the extent of any retained REIT taxable income under the present law section 179D deduction and investment credit regimes, or whether a REIT should be able to distribute the equivalent of this additional cash flow to shareholders in a form that is nontaxable to them. If the latter approach is adopted, consideration should be given to whether this benefit should be accorded to REIT shareholders, such as tax exempt, governmental, or foreign investors that are not eligible for the investment credit (including certain energy credits) under present law. Consideration might also be given to a partnership model for passing through a credit to shareholders, with or without a distribution from the entity. However, adopting such a model for REIT shareholders could involve similar issues with respect to particular types of shareholders, and could provide REIT shareholders with advantages not available to partnership investors unless passive loss rules and other limitations on investor use of credits that apply to partnerships are also applied to REIT shareholders.[142]

Finally, because the proposal eliminates the present law deduction, which applies through December 31, 2013, while allowing the credit only for property placed in service during calendar year 2012, some taxpayers relying on present law who have been planning on placing a building in service in 2013 may not be able to go forward with their plans if the deduction was a crucial

[142] If the investors had invested in a partnership rather than a REIT, and the partnership had made an investment eligible for a credit, partnership rules could permit an investor to take its allocable share of the credit without receiving any distribution from the partnership—a result that does not occur for a C corporation shareholder (including a REIT shareholder). However, tax exempt investors, investors that are governments, and foreign investors are not permitted to take an investment tax credit, including through a partnership investment. Secs. 50(b)(3) and 50(b)(4); secs.168(h)(5) and (6). In addition, for passive individual investors and certain trusts, estates, and closely held corporations, the passive loss rules of section 469 generally permit the credit to be used only against passive income from that partnership or other entities (but not against any investment income or active business income). Comparable rules would presumably have to be developed for REIT shareholders. It should be noted that REITs already can provide certain advantages to tax-exempt and foreign investors in real estate, as compared to partnerships. Tax-exempt investors in a real estate partnership would have unrelated business income if the partnership is leveraged, (as is commonly the case with real estate investment) a result that REIT investors avoid. Also, foreign investors in a real estate partnership would experience gain subject to tax under the Foreign Investment in Real Property Tax Act of 1980 (sec. 897), a result that can be avoided through certain REIT investments such as a less than 5-percent ownership interest in a publicly traded REIT.

financial component of their plans and if they cannot accelerate construction into 2012 to qualify for the credit.

Prior Action

No prior action.

PART III − INCENTIVES TO PROMOTE REGIONAL GROWTH

A. Extend and Modify the New Markets Tax Credit

Present Law

In general

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[143] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.[144] The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.[145] The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed.[146]

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities through their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE.[147] A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.[148] Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any

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[143] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

[144] Sec. 45D(a)(2).

[145] Sec. 45D(a)(3).

[146] Sec. 45D(g).

[147] Sec. 45D(c).

[148] Sec. 45D(b).

loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.[149]

A "low-income community" is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income.[150] For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary is authorized to designate "targeted populations" as low-income communities for purposes of the new markets tax credit.[151] For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994[152] (the "Act") to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.[153] A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391 of the Code, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of the business is used in a low-income community; (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community; and (4) less than five

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[149] Sec. 45D(d).

[150] Sec. 45D(e).

[151] Sec. 45D(e)(2).

[152] Pub. L. No. 103-325.

[153] Pub. L. No. 103-325.

percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.[154]

The maximum annual amount of qualified equity investments is $3.5 billion for each of the 2010 and 2011 calendar years.[155]

Alternative minimum tax

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax.[156] An individual's tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

The new markets tax credit cannot be used to offset AMT liability because business tax credits generally may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000).[157] Credits not allowed may be carried back one year and carried over for up to 20 years.

Description of Proposal

The proposal extends the new markets tax credit for one year, with an allocation amount of $5.0 billion, and would allow the new markets tax credit to be used to offset AMT liability.

Effective date.–The proposal is effective on the date of enactment.

Analysis

Extending the new markets tax credit

As of January 2010, Treasury had awarded all available (at the time) new markets tax credits.[158] From the first round of new markets tax credit allocations in 2003 through 2009,

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[154] Sec. 45D(d)(2).

[155] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 733 (December 17, 2010). This law also extends for two years, through 2016, the carryover period for unused new markets tax credits.

[156] Sec. 55(a).

[157] H.R. 992, Building American Jobs Act of 2011 (introduced in the House of Representatives on March 10, 2011) would allow the new markets tax credit to be used to offset AMT liability with respect to qualified investments made between March 15, 2010 and January 1, 2012.

[158] A total of $26 billion of credits had been allocated as of December 31, 2009. This amount does not include the $3.5 billion of credits which was allocated for each of 2010 and 2011. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 733 (December 17, 2010).

demand for the credit has exceeded available allocation authority by at least 4.5 times in each allocation round.[159] The fact that the program was oversubscribed when credits per investment totaled 39 percent suggests that the credit may have been more generous than would be required to encourage new investment, and the credit rate could have been lowered while funding more projects on the same budget.

Proponents of extending the new markets tax credit point to the demand for the credit and argue that the credit has proved to be an effective means of providing equity and other investments to benefit businesses in low income communities. Moreover, they argue that investor interest in new markets tax credits has remained high despite the turmoil in the economy. Thus, they argue the credit should be extended for at least one additional year.[160]

Others claim that a comprehensive review of the new markets tax credit program has not yet been performed so its effectiveness is unclear.[161] Similarly, it is not clear whether the investment in low income communities represents new investment that would not have occurred in the absence of the program.[162] To the extent the new markets tax credit is applied to investments that would have otherwise occurred, the impact of the credit is diminished. Those against extending the credit may note that corporate investors, which make the majority of investments in CDEs, are shifting investment into low-income communities from higher income communities while individual investors as a group appear to be making at least some new investments to participate in the new markets tax credit program.[163]

As originally enacted in 2000, $15 billion was allocated for the new markets tax credit program through 2007. Pub. L. No. 106-554. In 2005, an additional $1 billion of credits was allocated for qualified areas affected by Hurricane Katrina over a period of three years. The Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135 (December 21, 2005). In 2006 and again in 2008, another $3.5 billion was allocated. The Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 (December 20, 2006), and the Tax Extenders and Alternative Minimum Tax Act of 2008, Pub. L. No. 110-343 (October 3, 2008). In 2009, an additional $3 billion of credits was allocated to be split equally between the 2008 (retroactively) and 2009 allocations. The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (February 17, 2009).

[159] Government Accountability Office, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified*, GAO-10-334, January 2010, p. 4.

[160] The New Markets Tax Credit Coalition, *The New Markets Tax Credit: Progress Report 2009*, June 2009, p. 33-34 ("At a minimum, Congress should enact legislation…that not only extends the Credit for 5 years at $5 billion per year in Credit authority, but also provides [new markets tax credit] investors with AMT relief.")

[161] A complete accounting of the new markets tax credit benefits has not yet been performed. In the meantime, the GAO has provided new markets tax credit reports to Congress in 2004, 2007, and 2010. The 2007 and 2010 reports are discussed above. In 2004, the GAO determined that progress was being made in implementing the new markets tax credit program and recommended that the IRS and the Treasury work together to monitor compliance. Government Accountability Office, *New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance*, GAO-04-326, January 2004.

[162] Donald J. Marples, *New Markets Tax Credit: An Introduction*, CRS Report RL34402, March 16, 2010.

[163] Government Accountability Office, *New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, GAO-07-296, January 2007, p. 4.

Opponents of the proposal might argue that the proposal extends tax benefits not only to communities that have suffered a decline in manufacturing and retail establishments but also to neighboring, prospering communities.[164]

Opponents of the proposal may also argue that the new markets tax credit is too complex. As a result, CDEs are less likely to execute smaller transactions with the result that less equity may end up in low-income community businesses.[165] In addition, current economic conditions may have contributed to lower returns than investors are willing to accept to purchase the right to claim the new markets tax credit (and enjoy a similar return on investment as in previous years), which also decreases the amount of equity available for low-income community businesses.

Allowing the new markets tax credit to offset AMT liability

Proponents of allowing new markets tax credit investments to offset AMT liability argue that this will broaden the pool of potential investors and put the new markets tax credit on par with other tax credits that can offset the AMT liability, such as the low-income housing tax credit and the historic rehabilitation tax credit.[166] Additionally, an AMT liability offset may increase the amount that investors are willing to pay for the new markets tax credit. These two benefits − an increase in the pool of investors and an increase in the price investors are willing to pay for the credit may have the beneficial effect of ensuring that a larger portion of the subsidy ends up in the qualified active low-income community businesses.

Others note that future new markets tax credit allocations may be reduced as Federal revenue losses increase because investors subject to the AMT who are not currently investing in new market tax credits may become new market tax credit investors and claim credits that would otherwise go unclaimed. Opponents also may argue that to the extent there is already a sufficient pool of sufficient pool of new market tax credit investors, providing AMT relief may not provide any additional benefit to low income communities.

Prior Action

A proposal to extend the new markets tax credit for two years, with an allocation amount of $5.0 billion each year, was included in the President's fiscal year 2011 budget proposal. The

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[164] See, e.g., Sharyl Attkisson, "Fancy Hotel Renovated with Your Tax Dollars," *CBS News*, February 8, 2011, available at http://www.cbsnews.com/stories/2011/02/08/eveningnews/main7330767.shtml. Certain buildings in neighborhoods with relatively low poverty rates, including luxury hotels and museums, have been redeveloped through the New Markets program because the program focuses on the poverty rate among individuals in a community. Having individuals satisfy the poverty rate criteria as opposed to limiting the rules to families means that neighborhoods with lots of students as is the case in downtown Chicago would be eligible for New Markets tax credit projects even if though the poverty rate among families is very low.

[165] Government Accountability Office, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified*, GAO-10-334, January 2010, p. 41.

[166] The New Markets Tax Credit Coalition, *The New Markets Tax Credit: Progress Report 2009*, June 2009, p. 33-34

2011 budget proposal also included “other improvements to the NMTC,” which included permitting the credit to offset AMT liability.

B. Reform and Extend Build America Bonds

Present Law

Build America Bonds

Section 54AA, added to the Code by the American Recovery and Reinvestment Act of 2009 ("ARRA"),[167] permits an issuer to elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a "Build America Bond."[168] In general, Build America Bonds are taxable governmental bonds, the interest on which is subsidized by the Federal government by means of a tax credit to the holder ("tax-credit Build America Bonds") or, in the case of certain qualified bonds, a direct payment to the issuer ("direct-pay Build America Bonds").

Definition and general requirements

A Build America Bond is any State or local governmental obligation (other than a private activity bond) if the interest on such obligation would be (but for section 54AA) excludable from gross income under section 103,[169] and the issuer makes an irrevocable election to have the rules in section 54AA apply.[170] In determining if an obligation would be tax-exempt under section 103, the credit (or the payment discussed below for direct-pay Build America Bonds) is not treated as a Federal guarantee.[171] Further, for purposes of the restrictions on arbitrage in section 148, the yield on a tax-credit Build America Bond is determined without regard to the credit;[172] the yield on a direct-pay Build America Bond is reduced by the payment made pursuant to section 6431.[173] A Build America Bond does not include any bond if the issue price has more than a de minimis amount of premium over the stated principal amount of the bond.[174]

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[167] Pub. L. No. 111-5.

[168] Sec. 54AA.

[169] Thus, where a bond otherwise satisfies all of the requirements under section 103 to be treated as a tax-exempt bond (other than a private activity bond), it should be possible to issue such bond as a Build America Bond. *C.f.* CCA AM2009-014 (indicating that an Indian tribal government that received an allocation of volume cap pursuant to section 7871(f)(1) to issue Tribal Economic Development Bonds could issue such bonds as Build America Bonds rather than issuing them as tax-exempt bonds under section 103).

[170] Sec. 54AA(d). Subject to updated IRS reporting forms or procedures, an issuer of Build America Bonds makes the election required by 54AA on its books and records on or before the issue date of such bonds. IRS Notice 2009-26, 2009-16 I.R.B. 833 (April 20, 2009).

[171] Sec. 54AA(d)(2)(A). Section 149(b) provides that section 103(a) shall not apply to any State or local bond if such bond is federally guaranteed.

[172] Sec. 54AA(d)(2)(B).

[173] Sec. 6431(c).

[174] Sec. 54AA(d)(2)(C).

Treatment of holders of tax-credit Build America Bonds

The holder of a tax-credit Build America Bond accrues a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year.[175] The interest payment date is any date on which the holder of record of the Build America Bond is entitled to a payment of interest under such bond.[176] The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credit may be carried forward to succeeding taxable years.[177] The credit, as well as the interest paid by the issuer, is included in gross income, and the credit may be stripped under rules similar to those provided in section 54A regarding qualified tax credit bonds.[178] Rules similar to those that apply for S corporations, partnerships and regulated investment companies with respect to qualified tax credit bonds also apply to the credit.[179]

Special rules for direct-pay Build America Bonds

Under the special rule for qualified bonds, in lieu of the tax credit to the holder, the issuer is allowed a credit equal to 35 percent of each interest payment made under such bond.[180] A "qualified bond," that is, a direct-pay Build America Bond, is any Build America Bond issued as part of an issue if 100 percent of the excess of available project proceeds of such issue over the amounts in a reasonably required reserve with respect to such issue are to be used for capital expenditures.[181] Direct-pay Build America Bonds may not be issued to refinance capital expenditures in "refunding issues" (as defined in Treas. Reg. sec. 1.150-1).[182] Direct-pay Build

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[175] Sec. 54AA(a) and (b). Original issue discount ("OID") is not treated as a payment of interest for purposes of determining the credit under the provision. OID is the excess of an obligation's stated redemption price at maturity over the obligation's issue price (sec. 1273(a)).

[176] Sec. 54AA(e).

[177] Sec. 54AA(c).

[178] Sec. 54AA(f). See IRS Notice 2010-28, *Stripping Transactions for Qualified Tax Credit Bonds,* 2010-15 I.R.B. 541 (April 12, 2010).

[179] *Ibid.*

[180] Sec. 54AA(g)(1). OID is not treated as a payment of interest for purposes of calculating the refundable credit under the provision.

[181] Sec. 54AA(g).

[182] IRS Notice 2009-26. In contrast, tax-credit Build America Bonds "may be issued to finance the same kinds of expenditures (e.g., capital expenditures and working capital expenditures) and may involve the same kinds of financings (e.g., original new money financings, current refundings, and one advance refunding) as tax-exempt governmental bonds." *Ibid.*

America Bonds also must be issued before January 1, 2011. The issuer must make an irrevocable election to have the special rule for qualified bonds apply.[183]

The payment by the Secretary is to be made contemporaneously with the interest payment made by the issuer, and may be made either in advance or as reimbursement.[184] In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer.[185]

Description of Proposal

The proposal makes the direct-pay Build America Bonds program permanent at a Federal subsidy level equal to 28 percent of the coupon interest on the bonds. The proposed Federal subsidy level is intended to be approximately revenue neutral relative to the Treasury Department's estimated future Federal tax expenditure for tax-exempt bonds,

The proposal also expands the eligible uses for Build America Bonds to include the following: (1) original financing for governmental capital projects, as under the initial authorization of Build America Bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid promptly within ninety days of issuance of the current refunding bonds; (3) short-term governmental working capital financings for governmental operating expenses (such as tax and revenue anticipation borrowings for seasonal cash flow deficits), subject to a thirteen-month maturity limitation; and (4) financing for Section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities.

Effective date.−The proposal is effective for bonds issued after the date of enactment.

Analysis

In general

A recent Treasury report indicates that BABs have been used in all 50 States, the District of Columbia and two territories for $181 billion in Build American Bond ("BAB") financing of capital projects.[186] BABs were intended to assist State and local governments during the recent fiscal crisis by lowering borrowing costs and encouraging job growth by providing an additional method of finance for the building of capital projects. During 2008, as the financial problems worsened, investors sought the safety of U.S. Treasury bonds. The pool of investors for tax-exempt debt declined, and State and local governments had to offer higher interest rates to attract

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[183] Sec. 54AA(g)(2)(B). Subject to updated IRS reporting forms or procedures, an issuer of direct-pay Build America Bonds makes the election required by 54AA(g)(2)(B) on its books and records on or before the issue date of such bonds. IRS Notice 2009-26, 2009-16 I.R.B. 833.

[184] Sec. 6431.

[185] Sec. 6431(b).

[186] U.S. Treasury Department, *Treasury Analysis of Build America Bonds, Issuance, and Savings,* May 16, 2011, p. 2.

buyers for their bonds. As a result, State and local governments faced an environment of sharply increasing borrowing costs.

BABs address the borrowing-cost issues by providing a Federal subsidy of interest payments lessening the out-of-pocket costs for State and local governments,[187] and by broadening the pool of municipal bond investors to low tax and zero tax liability investors that normally would not hold tax-exempt debt. BAB issuers receive a subsidy of 35 percent of the interest paid to buyers of the bonds. This permits the issuers to pay interest rates that are competitive with rates paid on taxable debt by corporations and the Federal government. As a result, BABs have expanded the categories of municipal investors to those buyers such as pension funds and foreign entities without tax liability. Most BABs have been issued with long maturities, which makes the bonds attractive to investors looking for a stable, long-term, high rate of income and those trying to match income with their long-term obligations, such as pension funds.

Initially, issuers of long-term BABs obtained financing, after the application of the Federal subsidy, which was significantly less expensive than comparable tax-exempt debt. For example, California issued 30-year BABs at an interest rate of 7.4 percent, but after taking into account the Federal subsidy, subsidy California only has to pay net interest at 4.8 percent.

Over time, as the market for State and local debt adjusted to the new instrument, BABs net interest rates and tax-exempt bond interest rates began to converge as tax exempt bond interest rates began to fall. One reason for the fall in tax-exempt bond interest rates was the effect of increased issuances of BABs in reducing the available supply of traditional tax-exempt bond issuances. The lower supply of traditional tax-exempt bonds resulted in higher prices and lower interest rates on tax-exempt bonds.[188] Therefore, a secondary effect of the BABs program is that some of the benefit that used to accrue to the investor in tax exempt bonds now accrues to the State and local government in the form of lower tax-exempt bond interest rates.

Permanence

The President's budget proposal would make the direct-pay BAB program permanent, but at a lower rate. Some attributed the new and temporary nature of BABs to the existence of higher BAB interest rates than comparable corporate debt, and higher fees (e.g., underwriting fees) paid by issuers when compared with tax-exempt debt. An April 2010 Treasury Department analysis indicates that the financing costs for BABs declined over time.[189] Some would argue

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[187] In addition to reducing the out-of-pocket costs to State and local governments, the Federal subsidy may offer a measure of security for the investor as a portion of the interest is covered by the Federal government, thus encouraging the purchase of these bonds.

[188] See Bond Buyers 2010 in statistics, p. 4A, BABs Crimpt Tax-Exempts But Munis Set New Record (February 14, 2011).

[189] U.S. Treasury Department, *Treasury Analysis of Build America Bonds, Issuance, and Savings,* May 16, 2011, p. 10.

that permanence would strengthen the market for these bonds and permit them to be issued at lower interest rates and with lower associated fees.

As a new financial product, issuers and investors have to devote substantial resources to learn and understand the program. Market participants are more likely to devote resources necessary for issuer and investor education if the program is permanent than if there is uncertainty about the long-term prospects of a program that sunsets after two years. In addition, a permanent program may alleviate some of the uncertainty associated with a program that is continually extended, and, as such, receives periodic reevaluation that may result in substantial changes to the form of the program.

Opponents of the proposal would argue that the purpose of the BAB program was to provide temporary help to State and local governments during a period of financial crisis and therefore, the program should not be permanent.

Some may be concerned about a permanent program's effect on the Federal deficit. Although the program expired January 1, 2011, the Federal government's obligation to subsidize the interest payments continues for the life of the outstanding bonds. The program was without volume limitations and most BAB issuances were for the long-term, e.g., 20 to 30 years, thus committing the Federal government to significant costs for decades outside the 10-year budget window. Unlike spending programs that are generally part of an annual appropriations process, the outlays for the BAB program are treated as tax refunds which are outside the annual appropriations process.

Finally, some have questioned the fiscal health of municipalities. This raises the issue of whether it is appropriate for the Federal government to encourage more State and local spending through BABs and other special bond programs, which may exacerbate the fiscal problems of certain municipalities.

Reducing the 35-percent subsidy

At 35 percent, the BAB subsidy is significantly deeper than that provided by tax-exempt debt. The President' budget proposal would reduce the Federal subsidy from 35 percent of interest paid to 28 percent of interest paid.

For policy purposes, comparing the subsidy level of a BAB to the subsidy of a traditional tax-exempt bond requires a comparison of the after-subsidy BAB interest rate to the tax-exempt bond rate that the issuer would face in the absence of the BAB program. During 2008 the average yield on BABs was approximately 6.175 percent. For illustration purposes, assuming a similar pricing environment in the future the after-subsidy yield on BABs at the 28 percent credit rate proposed in the President's budget would be 4.45 percent. Between the years 2000 to 2007 the interest rate on municipal bonds was, on average, 79 percent of the interest rate on comparable corporate debt. Assuming a similar relationship in the future implies tax-exempt interest rates of 4.89 percent, which suggests that BABs provide an interest cost savings of approximately nine percent over tax-exempt bonds. While forecasting these relationships in the future is speculative, using data on the historical relationships between taxable and tax-exempt

debt suggest that BABs at the 28 percent credit rate still provide a deeper subsidy than comparable tax-exempt debt for at least some projects and, in particular, for long-term debt.

Expanded purposes

The President's budget proposal would allow current refundings of BABs in which the prior bonds are retired within 90 days after issuance of the current refunding bonds. Current refundings are done primarily to replace higher-rate debt with lower-rate debt to obtain interest cost savings. The interest cost savings in a current refunding of BABs would benefit both issuers (lower interest rates) and the Federal government (lower BABs subsidy rate). Historically, State and local government issuers have had a preference for debt with par call features after 10 years. In certain circumstances, issuers issue either noncallable bonds or bonds with significant "make whole" call premiums to preserve the economic terms of the original debt, and in these circumstances, current refunding will not produce interest cost savings.

The President's budget proposal would expand the permitted purposes beyond governmental capital projects, to include government working capital and projects for 501(c)(3) entities. These are purposes for which tax-exempt debt may be issued under present law, and so some argue that these expansions make BABs a more viable alternative to tax-exempt debt for State and local governments. Proponents argue that BABs are more efficient in delivering the Federal subsidy to the issuers than tax-exempt debt, and so this alternative should be further encouraged.

Because State and local government receipts from property and sales taxes often are uneven from month to month (due to seasonal or other timing issues), the governments issue tax-exempt debt to cover the temporary shortfall to cover operating expenses until the revenue is actually received. Some may argue that while there is a clear Federal interest in capital investment programs that could create jobs, the Federal interest in providing an increased subsidy for the financing working capital is less clear. As noted above, the budget proposal would extend BABs to financing for section 501(c)(3) entities. Some might argue this is appropriate as such entities are performing functions that might otherwise have to be done by government, and thus are performing a quasi-governmental function. However, some might question whether there is a significant Federal interest in subsidizing the expenditures of such private non-profit organizations.

Prior Action

A similar proposal was included in the President's fiscal year 2011 budget proposal.

C. Allow Low-Income Housing Tax Credit Properties to Elect to Use Average Tenant Incomes for Purposes of Applicable Income Tests

Present Law

Low-income housing credit

The low-income housing credit may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments of the credit have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Tax-exempt bonds for housing

Private activity bonds are bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes, but is not limited to, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified residential rental projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

Description of Proposal

The proposal would add a third criterion to the two described above. When a taxpayer elects this criterion, at least 40 percent of the units would have to be occupied by tenants with incomes that average no more than 60 percent of AMI. No rent-restricted unit, however, could be occupied by a tenant with income over 80 percent of AMI; and, for purposes of computing the

average, any unit with an income limit that is less than 20 percent of AMI would be treated as having a 20-percent limit.

For example, suppose that a building had 10 rent-restricted units with income limits of 20 percent of AMI, 10 with limits of 40 percent of AMI, 20 with limits of 60 percent of AMI, and 30 with limits of 80 percent of AMI. This would satisfy the new criterion because none of the limits exceeds 80 percent of AMI and the average does not exceed 60 percent of AMI. ($10\times20 + 10\times40 + 20\times60 + 30\times80 = 4200$, and $4200/70 = 60$.)

Effective date.−The proposal is effective for elections made after the date of enactment.

Analysis

Proponents may argue that the present-law rules only serve a "very narrow income band" and that this proposal will alleviate this condition. Opponents may respond that this proposal necessarily means that individuals in the "very narrow income band" will have less available housing because potential tenants both above and below such band may be substituted for units in the income band. That is, opponents may argue that this proposal may actually cost some presently eligible low-income tenants the opportunity to enjoy subsidized housing under this program. Opponents question whether other economic factors will operate to negate the perceived tax subsidy extended under the program. For example, the landlords of such low-income housing may look to the level of rent payments and the difficulty of rent collection of significantly lower-tenants as off-setting the tax benefit. Proponents may respond that historic participation levels in the low-income housing tax credit do not support this concern.

This proposal does not address the question whether the present-law income targeted rules that have been in place for decades and that are used to provide both tax and non-tax subsidies need to be more generally re-evaluated rather than on a piecemeal basis as in the instant case.

Proponents also argue that present-law does not result in adequate mixed-income housing. Opponents may respond that the level of mixed-income housing may be attributable to many factors other than the structure of the low-income housing tax credit.

Prior action

No prior action.

D. Expand the Low-Income Housing Additional Basis Rule to Certain Properties Which Also Receive Tax-Exempt Bond Financing

Present Law

Low-income housing credit

In general

The low-income housing credit may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments of the credit have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

High-cost areas

Three categories of buildings may be eligible for additional basis in calculating the low-income housing tax credit.

Generally, in the first two categories, buildings located in specified geographic areas (i.e., qualified census tracts and difficult development areas) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit is that the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of such statistical area.

The third category of buildings eligible for additional basis in calculating the low-income housing tax credit is composed of buildings designated by the State housing credit agency as requiring the enhanced credit in order for such building to be financially feasible. This category is not subject to the geographic limitation relating to the percentage of the population of each metropolitan statistical area or nonmetropolitan statistical area which may be designated for additional basis.

In all events the additional basis rule does not apply to any building if any portion of the building is financed with tax-exempt bonds subject to the private activity bond volume cap.

Explanation of Provision

The proposal expands the additional basis rule to a fourth category of buildings to be designated by the State housing credit agency for the jurisdiction in which the building is located. The mechanism for this increase remains the same as for the other three types of buildings (i.e., an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building).

Unlike present law, the additional basis rule under the proposal is available only to an otherwise eligible building if such building receives a requisite amount of financing with tax-exempt bonds subject to the private activity volume cap (described below).

Like the third present-law category, the proposed category is not subject to any geographic limitation capping the percentage of population of each metropolitan statistical area or nonmetropolitan statistical area which could be so designated.

Under the proposal eligible buildings must satisfy the following requirements: (1) the project of which the building is a part involves preservation, recapitalization, and rehabilitation of existing housing; (2) the building suffers from a serious backlog of capital improvements or deferred maintenance; (3) at least fifty percent of the aggregate basis of the building and the land on which the building is located is financed with tax-exempt bonds subject to the private activity volume cap; (4) the project of which the building is a part was previously financed with Federal funds (including the low-income housing tax credit); and (5) as a result of such financing with Federal funds (including the low-income housing tax credit), the building is subject to a long-term use agreement limiting occupancy to low-income households.

The new category would be subject to a separate volume limitation. Specifically, the aggregate issue price of tax-exempt bonds financing eligible buildings for each calendar year may not exceed 0.4 percent of the State's private activity bond volume cap for the year of the issuance (notwithstanding whether the volume cap for the bond issuance was a carry-forward from a prior calendar year).

Effective date.−The proposal is effective for buildings financed with tax-exempt bonds issued after the date of enactment.

Analysis

Proponents may argue that the stock of existing affordable housing in the United States is shrinking and that the proposal will subsidize preservation of this housing. Proponents cite oversubscription of the 70 percent credit as an argument for increasing the level of subsidy for the 30 percent credit. Opponents might respond that the 30 percent credit in conjunction with tax-exempt bond financing was designed to roughly equate to the 70 percent credit. Further, high demand for the 70 percent credit does not inform either way whether the proposed increase in the 30 percent credit is appropriate.

Opponents may also debate whether using the low-income housing tax credit to preserve the existing and aging low-income housing stock is the best housing policy. It can be argued that some of the existing housing should be replaced not refurbished. Proponents may respond that

the per-unit cost of restoration and preservation may be lower than the per-unit cost of new construction. For that reason, they argue, preservation is a more efficient use of scarce Federal resources.

Prior action

No prior action.

E. Designate Growth Zones

Present Law

The Code provides several incentives aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries referred to as empowerment zones, the District of Columbia Enterprise Zone (DC Zone), and the Gulf Opportunity (GO) Zone.[190] In the case of empowerment zones, the targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations. The DC Zone refers to certain economically depressed census tracts within the District of Columbia. The GO Zone is the portion of the Hurricane Katrina disaster area determined by the President to warrant assistance from the Federal Government.

The tax incentives under the empowerment zones program include a Federal income tax credit for employers who hire qualifying employees, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, deferral of capital gains tax on sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock. The wage credit, accelerated depreciation deductions on qualifying equipment, and tax-exempt bond financing are also available for businesses in the DC Zone. In addition, a zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years. The tax benefits for areas within the GO Zone include an increase in available tax-exempt bond financing, an increase in the allocation of low-income housing tax credit, an increase in the rehabilitation credit rate for structures located in the GO Zone, and an additional first-year depreciation deduction for qualified property.

The Code also provides for accelerated depreciation referred to as bonus for qualified property (purchased anywhere including within empowerment zones, the DC Zone, or the GO Zone) placed in service in 2011 and 2012.

Empowerment Zones

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 93")[191] authorized the designation of nine empowerment zones empowerment zones ("Round I empowerment zones")

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[190] There are also areas that were designated as renewal communities which received tax benefits that all expired as of December 31, 2009, except that a zero-percent capital gains rate applies with respect to gain from the sale through December 31, 2014 of a qualified community asset acquired after December 31, 2001, and before January 1, 2010 and held for more than five years. In addition, the Code authorizes an aggregate of $8 billion in tax-exempt private activity bonds for the purpose of financing the construction and repair of infrastructure in New York City referred to as "Liberty Zone bonds." The bonds must be issued by December 31, 2011.

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

to provide tax incentives for businesses to locate within certain targeted areas[192] designated by the Secretaries of the Department of Housing and Urban Development ("HUD") and the U.S Department of Agriculture ("USDA"). The Taxpayer Relief Act of 1997[193] authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones ("Round II empowerment zones"). The Community Renewal Tax Relief Act of 2000 ("2000 Community Renewal Act")[194] authorized a total of ten new empowerment zones ("Round III empowerment zones"), bringing the total number of authorized empowerment zones to 40.[195] In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009.[196]

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Tax Act") extended for two years, through December 31, 2011, the period for which the designation of an empowerment zone is in effect, thus extending for two years the empowerment zone tax incentives, including the wage credit, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, and deferral of capital gains tax on sale of qualified assets sold and replaced.[197] The Tax Act also extended for two years, through December 31, 2016, the period for which the percentage exclusion for qualified small business stock (of a corporation which is a qualified business entity) acquired on or before February 17, 2009 is 60 percent. Gain attributable to periods after December 31, 2016 for qualified small business stock

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[192] The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

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

[194] Pub. L. No. 106-554.

[195] The urban part of the program is administered by the HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA; Baltimore, MD, Chicago, IL; Cleveland, OH; Detroit, MI; Los Angeles, CA; New York, NY; and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY; Mid-Delta, MI; and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA; Cincinnati, OH; Columbia, SC; Columbus, OH; Cumberland County, NJ; El Paso, TX; Gary/Hammond/East Chicago, IN; Ironton, OH/Huntington, WV; Knoxville, TN; Miami/Dade County, FL; Minneapolis, MN; New Haven, CT; Norfolk/Portsmouth, VA; Santa Ana, CA; and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA; Griggs-Steele, ND; Oglala Sioux Tribe, SD; Southernmost Illinois Delta, IL; and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA; Jacksonville, FL; Oklahoma City, OK; Pulaski County, AR; San Antonio, TX; Syracuse, NY; Tucson, AZ; and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME; and Futuro, TX.

[196] If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

[197] Pub. L. No. 111-312. In the case of a designation of an empowerment zone the nomination for which included a termination date which is December 31, 2009, termination shall not apply with respect to such designation if the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary may provide.

acquired on or before February 17, 2009 or after December 31, 2011 is subject to the general rule which provides for a percentage exclusion of 50 percent.

The following is a description of the tax incentives available under the empowerment zones program.

Employment credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (i.e., a maximum credit of $3,000 with respect to each qualified employee) who (1) is a resident of the empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.[198]

The wage credit rate applies to qualifying wages paid before January 1, 2012. Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business."[199]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[200] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[201] In addition, the $15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[202] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[203]

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[198] Sec. 1396. The $15,000 limit is annual, not cumulative such that the limit is the first $15,000 of wages paid in a calendar year which ends with or within the taxable year.

[199] Secs. 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to: (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

[200] Sec. 280C(a).

[201] Secs. 1396(c)(3)(A) and 51A(d)(2).

[202] Secs. 1396(c)(3)(B) and 51A(d)(2).

[203] Sec. 38(c)(2).

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $535,000 in 2010 and 2011)[204] for qualified zone property placed in service before January 1, 2012.[205] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $2,000,000.[206] The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[207]

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than five percent of

[204] The Small Business Jobs Act of 2010, Pub. L. No. 111-240.

[205] Secs. 1397A, 1397D. The dollar limitation was changed in Pub. L. No. 111-240.

[206] Secs. 1397A(a)(2), 179(b)(2), (7).

[207] Sec. 1397C(b).

the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.[208]

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.[209] In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

Expanded tax-exempt financing for certain zone facilities

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.[210] These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).[211]

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as

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[208] Sec. 1397C(c).

[209] Sec. 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. Sec. 144(c)(6).

[210] Sec. 1394.

[211] Sec. 1394(b)(3).

long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed $60 million for an empowerment zone in a rural area, $130 million for an empowerment zone in an urban area with zone population of less than 100,000, and $230 million for an empowerment zone in an urban area with zone population of at least 100,000.

Elective roll over of capital gain from the sale or exchange of any qualified empowerment zone asset purchased after December 21, 2000

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset[212] held for more than one year and replaced within 60 days by another qualified empowerment zone asset in the same zone.[213] The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

Partial exclusion of capital gains on certain small business stock

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.[214] The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[215] A percentage of the excluded gain is an alternative minimum

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[212] The term "qualified empowerment zone asset" means any property which would be a qualified community asset (as defined in section 1400F, relating to certain tax benefits for renewal communities) if in section 1400F: (i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in section 1397C) were substituted for references to renewal community businesses, and (iii) the date of the enactment of this paragraph were substituted for "December 31, 2001" each place it appears. Sec. 1397B(b)(1)(A).

A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in an enterprise zone business), (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in an enterprise zone business), and (3) qualified community business property (meaning tangible property originally used in a enterprise zone business by the taxpayer) that is purchased or substantially improved after the date of the enactment of this paragraph.

For the definition of "enterprise zone business," see text accompanying *supra* note 207. For the definition of "qualified business," see text accompanying *supra* note 207.

[213] Sec. 1397B.

[214] Sec. 1202.

[215] Sec. 1(h).

tax preference;[216] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of 14 percent under the regular tax[217] and (i) 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.[218]

Temporary increases in exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, is increased to 75 percent.

The percentage exclusion for qualified small business stock acquired after September 27, 2010, and before January 1, 2012, is increased to 100 percent.

The temporary increases in the exclusion percentage apply for all qualified small business stock, including stock of empowerment zone businesses.[219]

Other tax incentives

Other incentives not specific to empowerment zones but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to $2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone, or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

DC Zones

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the "District of Columbia Enterprise Zone," or "DC Zone,"

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[216] Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

[217] The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

[218] The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

[219] Secs. 1202(a)(3)(B) and 1202(a)(4)(B).

within which businesses and individual residents are eligible for special tax incentives. The census tracts that comprise the District of Columbia Enterprise Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District of Columbia), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The District of Columbia Enterprise Zone designation remains in effect for the period from January 1, 1998, through December 31, 2011.

The following tax incentives are available for businesses located in an empowerment zone and the District of Columbia Enterprise Zone is treated as an empowerment zone for this purpose: (1) 20-percent wage credit, (2) an additional $35,000 of section 179 expensing for qualified zone property, and (3) expanded tax-exempt financing for certain zone facilities. In addition, a zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years.

Present law also provides for a nonrefundable tax credit for first-time homebuyers of a principal residence in the District of Columbia.

Employment credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (i.e., a maximum credit of $3,000 with respect to each qualified employee) who (1) is a resident of the District of Columbia, and (2) performs substantially all employment services within an empowerment zone in a trade or business of the employer.

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2012. Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business," as defined below.

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year. Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A. In addition, the $15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit. The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $535,000 in each of 2010 and 2011)[220] for qualified zone property placed in service after December 31, 2001, and before January 1, 2012. The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $2,000,000. The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. For this purpose, special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.

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[220] The Small Business Jobs Act of 2010, Pub. L. No. 111-240.

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit. In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

Expanded tax-exempt financing for certain zone facilities

An enterprise zone business is permitted to borrow proceeds from the issuance of tax-exempt enterprise zone facility bonds (as defined in section 1394, without regard to the employee residency requirement) issued by the District of Columbia. To qualify, 95 percent (or more) of the net proceeds must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property. Accordingly, most of the proceeds have to be used to finance certain facilities within the DC Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per enterprise zone business may not exceed $15 million and may be issued only while the DC Zone designation is in effect, from January 1, 1998 through December 31, 2011.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years. In general, a "qualified DC Zone asset" means stock or partnership interests held in, or tangible property held by, a DC Zone business. For purposes of the zero-percent capital gains rate, the DC Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than ten percent.

In general, gain eligible for the zero-percent tax rate is that from the sale or exchange of a qualified DC Zone asset that is (1) a capital asset or (2) property used in a trade or business, as

defined in section 1231(b). Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified DC Zone business. However, no gain attributable to periods before January 1, 1998, and after December 31, 2016, is qualified capital gain.

District of Columbia homebuyer tax credit

First-time homebuyers of a principal residence in the District of Columbia qualify for a tax credit of up to $5,000. The $5,000 maximum credit amount applies both to individuals and married couples. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000 and $130,000 for joint filers). The credit is available with respect to purchases of existing property as well as new construction.

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies. A taxpayer will be treated as a first-time homebuyer with respect to only one residence--i.e., a taxpayer may claim the credit only once. A taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.

The first-time homebuyer credit is a nonrefundable personal credit and may offset the regular tax and the alternative minimum tax. Any credit in excess of tax liability may be carried forward indefinitely. The homebuyer credit is generally available for property purchased after August 4, 1997, and before January 1, 2010. However, the credit does not apply to the purchase of a residence after December 31, 2008 to which the national first-time homebuyer credit under Section 36 of the Code applies.

GO Zone

Increase in rehabilitation credit

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable

year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Present law increases from 20 to 26 percent, and from 10 to 13 percent, respectively, the credit under section 47 with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone, provided the qualified rehabilitation expenditures with respect to such buildings or structures are incurred on or after August 28, 2005, and before January 1, 2012.

Low-income housing credit rules

In general

The low-income housing credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Volume limit

Generally, a low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Each State has a limited amount of low-income housing credit available to allocate. This amount is called the aggregate housing credit dollar amount (or the "State housing credit ceiling"). For each State, the State housing credit ceiling is the sum of four components: (1) the unused housing credit ceiling, if any, of such State from the prior calendar year; (2) the credit ceiling for the year (either a per capital amount or the small State minimum annual cap); (3) any returns of credit ceiling to the State during the calendar year from previous allocations; and (4) the State's share, if any, of the national pool of unused credits from other States that failed to use them (only States which allocated their entire credit ceiling for the preceding calendar year are eligible for a share of the national pool. For calendar year 2010, each State's credit ceiling is $2.10 per resident, with a minimum annual cap of $2,430,000 for certain small population States.[221] These

[221] Rev. Proc. 2009-50.

amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

Under section 1400N(c) of the Code, the otherwise applicable State housing credit ceiling is increased for each of the States within the Gulf Opportunity Zone. This increase applies to calendar years 2006, 2007, and 2008. The additional volume for each of the affected States equals $18.00 times the number of such State's residents within the Gulf Opportunity Zone. This amount is not adjusted for inflation. This additional volume limit expires unless the applicable low-income buildings are placed in service before December 31, 2011.

Tax-exempt bond financing

In general

Under present law, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes an exempt facility bond and a qualified mortgage bond.

Exempt facility bonds

The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

Residential rental property may be financed with exempt facility bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test").

Qualified mortgage bonds

Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including

income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a "first-time homebuyer" requirement. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or replace existing mortgages.

Exceptions to the new mortgage requirement are provided for the replacement of construction period loans, bridge loans, and other similar temporary initial financing. In addition, qualified rehabilitation loans may be used, in part, to replace existing mortgages. A qualified rehabilitation loan means certain loans for the rehabilitation of a building if there is a period of at least 20 years between the date on which the building was first used (the "20 year rule") and the date on which the physical work on such rehabilitation begins and the existing walls and basis requirements are met. The existing walls requirement for a rehabilitated building is met if 50 percent or more of the existing external walls are retained in place as external walls, 75 percent or more of the existing external walls are retained in place as internal or external walls, and 75 percent or more of the existing internal structural framework is retained in place. The basis requirement is met if expenditures for rehabilitation are 25 percent or more of the mortgagor's adjusted basis in the residence, determined as of the later of the completion of the rehabilitation or the date on which the mortgagor acquires the residence.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Qualified home-improvement loans may not exceed $15,000, and may not be used to refinance existing mortgages.

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the "State volume cap").

Gulf Opportunity Zone Bonds

The Gulf Opportunity Zone Act of 2005 authorizes Alabama, Louisiana, and Mississippi (or any political subdivision of those States) to issue qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone ("Gulf Opportunity Zone Bonds"). Gulf Opportunity Zone Bonds are not subject to the State volume cap. Rather, the maximum aggregate amount of Gulf Opportunity Zone Bonds that may be issued in any eligible State is limited to $2,500 multiplied by the population of the respective State within the Gulf Opportunity Zone.

Depending on the purpose for which such bonds are issued, Gulf Opportunity Zone Bonds are treated as either exempt facility bonds or qualified mortgage bonds. Gulf Opportunity Zone Bonds are treated as exempt facility bonds if 95 percent or more of the net proceeds of such bonds are to be used for qualified project costs located in the Gulf Opportunity Zone. Qualified project costs include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property (including buildings and their structural components and fixed improvements associated with such property), qualified residential rental projects (as defined in

section 142(d) with certain modifications), and public utility property. Bond proceeds may not be used to finance movable fixtures and equipment.

Rather than applying the 20-50 and 40-60 test from section142, a project is a qualified residential rental project under the provision if 20 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income or if 40 percent or more of the residential units in such project are occupied by individuals whose income is 70 percent or less of area median gross income.

Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone are treated as qualified mortgage bonds if the general requirements for qualified mortgage bonds are met. The Code also provides special rules for Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone. For example, the first-time homebuyer rule is waived and the income and purchase price rules are relaxed for residences financed in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. In addition, the Code increases from $15,000 to $150,000 the amount of a qualified home-improvement loan with respect to residences located in the specified disaster areas.

Also, a qualified GO Zone repair or reconstruction loan is treated as a qualified rehabilitation loan for purposes of the qualified mortgage bond rules. Thus, such loans financed with the proceeds of qualified mortgage bonds and Gulf Opportunity Zone Bonds may be used to acquire or replace existing mortgages, without regard to the existing walls or 20 year rule under present law. A qualified GO Zone repair or reconstruction loan is any loan used to repair damage caused by Hurricane Katrina, Hurricane Rita, or Hurricane Wilma to a building located in the GO Zones (or reconstruction of such building in the case of damage constituting destruction) if the expenditures for such repair or reconstruction are 25 percent or more of the mortgagor's adjusted basis in the residence. For these purposes, the mortgagor's adjusted basis is determined as of the later of (1) the completion of the repair or reconstruction or (2) the date on which the mortgagor acquires the residence.

Gulf Opportunity Zone Bonds must be issued before December 31, 2011.

Gulf Opportunity Zone Additional Depreciation

A discussion of the additional first-year depreciation deduction for specified Go Zone extension property can be found under the section discussing "Bonus Depreciation," below.

Bonus Depreciation

In general

An additional first-year depreciation deduction is allowed equal to 100 percent of the adjusted basis of qualified property placed in service after September 8, 2010, and before January 1, 2012 (before January 1, 2013, for certain longer-lived and transportation property),

and an additional 50-percent first-year depreciation deduction[222] is allowed for qualified property placed in service after December 31, 2011, and before January 1, 2013, (after December 31, 2012, and before January 1, 2014, for certain longer-lived and transportation property). The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits.[223]

50-percent additional first year depreciation

Property qualifying for the 50-percent additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[224] Second, the original use[225] of the property must commence with the taxpayer after December 31, 2007.[226] Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2013. An extension of the placed in service date of one year is provided for certain property with a recovery period of 10 years or longer and certain transportation property.[227] Transportation

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[222] An additional first-year depreciation deduction is also allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property).

[223] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

[224] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

[225] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[226] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

[227] Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding $1 million.

property generally is defined as tangible personal property used in the trade or business of transporting persons or property.

To qualify for the 50-percent additional first-year depreciation deduction, property generally must be acquired (1) after December 31, 2007, and before January 1, 2013 (before January 1, 2014 in the case of certain longer-lived and transportation property), but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2013.[228] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2013. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2013 ("progress expenditures") is eligible for the additional first-year depreciation deduction.[229]

Property does not qualify for the 50-percent additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

In the case of the 50-percent additional first year depreciation deduction, the basis of the property is appropriately adjusted to reflect the additional first-year depreciation deduction. Nevertheless, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

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[228] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

[229] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

The interaction of the additional first-year 50-percent depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2012, a taxpayer purchased new depreciable property and placed it in service.[230] The property's cost is $1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is $500. The remaining $500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or $100, is also allowed as a depreciation deduction in 2012. The total depreciation deduction with respect to the property for 2012 is $600. The remaining $400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

100-percent additional first-year depreciation

Property qualifies for the 100-percent additional first-year depreciation if it meets the requirements for the 50-percent additional first-year depreciation and also meets the following requirements. First, the taxpayer acquires the property after September 8, 2010 and before January 1, 2012.[231] Second, the taxpayer must place the property in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 in the case of certain longer-lived and transportation property). Third, the original use of the property must commence with the taxpayer after September 8, 2010.

Election to accelerate certain credits in lieu of claiming bonus depreciation

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional minimum tax credits in lieu of claiming depreciation under section 168(k) for "eligible qualified property" placed in service after December 31, 2010, and before January 1, 2013 (January 1, 2014 in the case of certain longer-lived and transportation property).[232] The provision applies with respect to "round 2 extension property," which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the additional first-year depreciation deduction for certain property placed in service after December 31, 2010.[233] A corporation making the election forgoes the

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[230] Assume that the cost of the property is not eligible for expensing under section 179.

[231] For a definition of "acquire" for this purpose, see section 3.02(1)(a) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664.

[232] A similar election could be made by a corporation otherwise eligible for the additional first year depreciation deduction under section 168(k)(4) for eligible qualified property placed in service after March 31, 2008, and before December 31, 2008. A separate election could also be made by a corporation otherwise eligible for the additional first year depreciation deduction with respect to extension property which is certain property placed in service in 2009 (2010 in the case of certain longer-lived and transportation property). Those prior elections could be used to increase the general business credit limitation s for a portion of unused research credits.

[233] An election under new section 168(k)(4)(I) with respect to round 2 extension property is binding for any property that is eligible qualified property solely by reason of the amendments made by section 401(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (and the application of such extension to this paragraph pursuant to the amendment made by section 401(c)(1) of such Act), even if such property is placed in service in 2012.

depreciation deductions allowable under section 168(k) and instead increases the limitation under section 53(c) on the use of minimum tax credits.[234] The increase in the allowable credits is treated as refundable. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation[235] for certain eligible qualified property that could be claimed as a deduction absent an election under this provision. Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after December 31, 2010; (2) the taxpayer must purchase the property either (a) after December 31, 2010, and before January 1, 2013, but only if no binding written contract for the acquisition is in effect before January 1, 2008,[236] or (b) pursuant to a binding written contract that was entered into after December 31, 2007, and before January 1, 2013;[237] and (3) the property must be placed in service after December 31, 2010, and before January 1, 2013 (January 1, 2014 for certain longer-lived and transportation property).

The bonus depreciation amount is limited to the lesser of: (1) $30 million, or (2) six percent of the minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.[238]

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[234] Special rules apply to an applicable partnership.

[235] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and the shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

[236] In the case of passenger aircraft, the written binding contract limitation does not apply.

[237] Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

[238] Under the provision, a taxpayer that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable years ending after March 31, 2008, or for extension property, may choose not to make this election for round 2 extension property. Further, the provision allows a taxpayer that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008, or for extension property, to make the election for round 2 extension property for its first table year ending after December 31, 2010, and for each subsequent year. In the case of a taxpayer electing to increase the research or minimum tax credit for eligible qualified property and/or extension property and the minimum tax credit for round 2 extension property, a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group. In computing the maximum amount, the maximum increase amount for extension property or for round 2 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property or round 2 extension property, respectively.

Gulf Opportunity Zone Additional Depreciation

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of specified qualified Gulf Opportunity Zone extension property. To qualify, property generally must be placed in service on or before December 31, 2011. Specified Gulf Opportunity Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a building described in (1), property described in section 168(k)(2)(A)(i),[239] if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service. However, in the case of nonresidential real property or residential rental property, only the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2012 is eligible for the additional first-year depreciation.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone which are in a county or parish which is identified by the Secretary of the Treasury (or his delegate) as being a county or parish in which hurricanes occurring in 2005 damaged (in the aggregate) more than 60 percent of the housing units in such county or parish which were occupied (determined according to the 2000 Census).

Description of Proposal

The proposal designates 20 growth zones (14 in urban areas and six in rural areas). The zone designation and corresponding tax incentives would be in effect from January 1, 2012 through December 31, 2016. The Secretary of Commerce would select the zones in consultation with the Secretary of Housing and Urban Development and the Secretary of Agriculture.

The zones would be chosen through a competitive application process. A State, county, city, or other general purpose political subdivision of a State or possession (a "local government"), or an Indian tribal government would be eligible to nominate an area for growth zone status. Areas could be nominated by more than one local government or State. In addition, local governments within a region could join together to jointly nominate multiple areas for growth zone status, so long as each designated zone independently satisfies the eligibility criteria. To be eligible to be nominated, an area must satisfy the following criteria:

1. A nominated area would have to have a continuous boundary (that is, an area must be a single area; it cannot be compromised of two or more separate areas) and could not exceed 20 square miles if an urban area or 1,000 square miles if a rural area.

[239] Generally, property described in section 168(k)(2)(A)(i) is (1) property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), or (4) certain leasehold improvement property.

2. A nominated urban area would have to include a portion of at least one local government jurisdiction with a population of at least 50,000. The population of a nominated urban area could not exceed the lesser of: (1) 200,000; or (2) the greater of 50,000 or ten percent of the population of the most populous city in the nominated area. A nominated rural area could not have a population that exceeded 30,000.

Nominated areas would be designated as growth zones based on the strength of the applicant's "competitiveness plan" and its needs to attract investment and jobs. Communities would be encouraged to develop a strategic plan to build on their economic strengths and outline targeted investments to develop their competitive advantages. Collaboration across a wide range of stakeholders would be useful in developing a coherent and comprehensive strategic plan. A successful plan would clearly outline how the economic strategy would connect the zone to drivers of regional economic growth.

In evaluating applications, the Secretary of Commerce could consider other factors, including: unemployment rates, poverty rates, household income, homeownership, labor force participation and educational attainment. In addition, the Secretary may set minimal standards for the levels of unemployment and poverty that must be satisfied by the nominated area.

"Rural area" would be defined as any area that is (1) outside of a metropolitan statistical area (within the meaning of section 143(k)(2)(B)) or (2) determined by the Secretary of Commerce, after consultation with the Secretary of Agriculture, to be a rural area. "Urban area" would be defined as any area that is not a rural area.

Two tax incentives would be applicable to growth zones. First, an employment credit would be provided to businesses that employ zone residents. The credit would apply to the first $15,000 of qualifying zone employee wages. The credit rate would be 20 percent for zone residents who are employed within the zone and 10 percent for zone residents employed outside of the zone. The definition of a qualified zone employee would follow rules found in section 1396(d). For the purposes of the 10 percent credit, the requirement that substantially all of the services performed by the employee for the employer are within the zone would not apply. The definition of qualified zone wages would follow the definitions provided in section 1396(c) and 1397(a).

Second, qualified property placed in service within the zone would be eligible for additional first-year depreciation of 100 percent of the adjusted basis of the property. Qualified property for this purpose includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. Qualified property must be new property. Qualified property excludes property that is required to be depreciated under the ADS. The taxpayer must purchase (or begin the manufacture or construction of) the property after the date of zone designation and before January 1, 2017 (but only if no written binding contract for the acquisition was in effect before zone designation). The property must be placed in service within the zone before January 1, 2017.

The Secretary of the Treasury would be given authority to collect data from taxpayers on the use of such tax incentives by zone. The Secretary of Commerce may require the nominating local government to provide other data on the economic conditions in the zones both before and

after designation. These data would be used to evaluate the effectiveness of the growth zones program.

Effective date.–The proposal is effective on the date of enactment.

Analysis

In general

The proposed growth zones are similar in many ways to present and prior law incentives related to empowerment zones, enterprise communities, and renewal communities, as described above.

The proposal is designed to promote job creation and investment in economically distressed areas that have demonstrated potential for future growth and diversification into new industries. The growth zones would replace the empowerment zone tax incentives which are set to expire at the end of 2011.

Opponents of the proposal might argue that the tax benefits may do little to encourage new development. Hence, such incentives may primarily benefit existing businesses while producing little new growth. Indeed, the establishment of local tax incentives may have the effect of distorting the location of new investment, rather than increasing investment overall.[240] If the new investments are offset by less investment in neighboring, but not qualifying areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

Opponents may also argue that there may be negative behavioral effects resulting from the announcement of the program and its temporary nature. Companies may delay certain investments in areas during the application process to avoid hiring or placing property in service before the growth zone tax benefits are available. This behavior could have the effect of suppressing economic activity in advance of the designation of a growth zone. Proponents may argue that this behavior would be offset because at the end of the period there is an incentive to accelerate hiring and investments such that wages are paid and property is placed in service before the expiration of the growth zone tax benefits.

Effectiveness of existing incentives

The Department of Housing and Urban Development, the Government Accountability Office, and various scholars have analyzed the effectiveness of present law empowerment zones and related tax incentives as discussed below.

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[240] For a discussion of the economic effects of targeting economic activity to specific geographic areas, see Leslie E. Papke, "What Do We Know About Enterprise Zones," in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 7, Cambridge, MA, The MIT Press (1993).

Department of Housing and Urban Development Analysis

HUD has not published any comprehensive study of the empowerment zones and renewal communities programs. However, in 2001, it published an interim assessment based on the initial years of the program.[241] The report was titled an "interim" assessment because it studied only the first five years of the ten-year program. No subsequent "final" assessment has yet been issued by HUD.[242]

HUD's interim assessment studied the performance of six urban Round I empowerment zones and 12 urban enterprise communities over the first five years of the empowerment zone/enterprise community program. The report analyzed performance based on four metrics: economic opportunity, community-based partnerships, sustainable community development, and strategic vision for change. Applicants for empowerment zone designation were required to incorporate these four principles into the strategic plans submitted with their applications.

HUD made several findings consistent with a positive impact by the empowerment zone/enterprise community program: in aggregate, job growth accelerated in the six empowerment zones; job growth in four of the six empowerment zones outpaced job growth in comparison areas; the number of both empowerment zone resident–owned and minority-owned businesses increased substantially across all six empowerment zones; and workforce development activities created as many as 16,000 jobs for empowerment zone/enterprise community residents.

On the other hand, other findings were consistent with little or no positive impact. During the period studied, there was a general economic upturn, making it difficult to attribute employment growth to the empowerment zone/enterprise community program. In some empowerment zones, employment increases may have been attributable to nonempowerment zone activities. Of the businesses in the six empowerment zones, only 11 percent reported using empowerment zone employment credits, four percent reported using section 179 expensing, and three percent reported using work opportunity tax credits, while 65 percent of all empowerment zone businesses reported no benefits from being located in the empowerment zone.

Ultimately, the HUD study's mixed results were inconclusive and did not show that the empowerment zone/enterprise community program causes community improvement.

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[241] U.S. Department of Housing and Urban Development, *Interim Assessment of the Empowerment Zones and Enterprise Communities (EZ/EC) Program: A Progress Report*, November 2001.

[242] In 2006, HUD published *Spotlight on Results*, an anecdotal report of the empowerment zone/enterprise community/renewal community programs' success. U.S. Department of Housing and Urban Development, *Spotlight on Results: Capturing Successes in Renewal Communities and Empowerment Zones*, May 2006. Through numerous stories and photos of individual community initiatives and projects, the report "highlights the successes of the tax incentives and celebrates successful programs and projects taking place in RCs and EZs." *Ibid.*, p. iii.

Government Accountability Office Analysis

In accordance with the Community Renewal Tax Relief Act of 2000,[243] which mandated that GAO issue reports of the empowerment zone/enterprise community programs and the renewal community program in 2004, 2007, and 2010, GAO has published periodic audits focusing on the programs' effects on poverty, unemployment, and economic growth.[244]

In its 2004 report, GAO found that the IRS did not collect sufficient data on the use of many of the empowerment zone/enterprise community and renewal community tax benefits.[245] It consequently found it impossible to study the overall impact of the empowerment zone/enterprise community program and renewal community program, and it recommended better data collection.[246]

GAO's second report concluded that the effects of Round I empowerment zone/enterprise community designation on community improvement were unclear.[247] GAO noted that the Department of Health and Human Services ("HHS"), HUD, and the United States Department of Agriculture ("USDA")—the three agencies that oversee the spending of grant funds under the empowerment zone/enterprise community program—had failed to collect data on how the grant funds were used.[248] Similarly, GAO found only limited data on the use of tax benefits, noting that HUD, USDA, and IRS had failed to reach agreement on a cost-effective approach to collect data and to identify standards for evaluating the effectiveness of those tax benefits.[249]

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[243] Pub. L. No. 106-554.

[244] Prior to the creation in 2000 of renewal communities, GAO issued reports about the use of tax incentives by empowerment zones and enterprise communities. See U.S. General Accounting Office, *Community Development: Information on the Use of Empowerment Zone and Enterprise Community Tax Incentives*, GAO-98-203, June 1998; U.S. General Accounting Office, *Community Development: Businesses' Use of Empowerment Zone Tax Incentives*, GAO-99-253, September 1999.

[245] The report describes renewal communities but does not analyze their effectiveness. U.S. General Accounting Office, *Community Development: Federal Revitalization Programs Are Being Implemented, but Data on the Use of Tax Benefits Are Limited*, GAO-04-306, March 2004, p. 45.

[246] *Ibid.*, p. 45-46.

[247] U.S. Government Accountability Office, *Empowerment Zone and Enterprise Community Program: Improvements Occurred in Communities, but the Effect of the Program is Unclear*, GAO-06-727, September 2006, p. 4. While the report briefly mentioned renewal communities, it focused its analysis on the empowerment zone and enterprise community programs, since more data (dating back to 1994) existed for those programs.

[248] "HHS did not provide the states, EZs, and ECs with clear guidance on how to monitor the program grant funds, so the types and extent of monitoring performed by state and local participants varied. To some extent, the lack of reporting requirements may be an outcome of the program's design, which was intended to give communities flexibility in using program funds and relied on multiple agencies for oversight. But the result has been that little information is available on the amount of funds spent on specific activities, hindering the agencies' efforts to oversee the program." *Ibid.,* p. 4.

[249] *Ibid.*

Using available data on the eight Round I empowerment zones, GAO conducted a statistical study of economic data to measure the economic impact of empowerment zone/enterprise community designation. It found that "although improvements in poverty, unemployment, and economic growth had occurred," the analysis "could not tie these changes definitively to the empowerment zone designation."[250] The lack of data, combined with the difficulty of determining which changes would have occurred in each area in the absence of empowerment zone/enterprise community designation, made measurement of program impact particularly difficult.

Among its concluding observations, the GAO recommended that if Congress authorizes similar programs in the future, it should address limitations in agency oversight and coordination and the limited ability to evaluate program effectiveness due to insufficient data.[251]

Its most recent report[252] provides an overview of the various revitalization programs with an emphasis on Round III empowerment zones and renewal communities that primarily received tax benefits. The results of this analysis may be the most informative for the Administration proposed growth zones, which exclusively provide two tax incentives. GAO noted that while some information on the use of tax benefits is available, data on the use of revitalization program tax benefits at the zone or community level and their impacts are limited.

Administrators for urban empowerment zones reported $643 million in facility bonds were used to finance 40 projects over 16 years; however, fewer than half of the zones reported using facility bonds at all.[253] Local renewal community administrators reported allocating $1.7 billion in commercial revitalization deductions from 2002 through 2008, representing just over 50 percent of possible total allocations.[254] They suggested that allowing pooling of unused allocations would permit usage in areas of greater demand.[255]

GAO noted that challenges exist in assessing the effectiveness of tax benefits because most IRS forms incorporating zone "tax benefits are not specific to revitalization program activities, with the exception of IRS Form 8844" related to employment credits.[256] IRS reported

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[250] *Ibid.*, p. 5. The report observes that nonempowerment zone areas used for comparison often had similar decreases in poverty and unemployment and increases in economic growth. In addition, the decrease in poverty within some empowerment zones was likely attributable to low-income residents moving out of the empowerment zone and being replaced by higher-income individuals.

[251] *Ibid.*, pp. 5-6, 48-49.

[252] U.S. Government Accountability Office, *Revitalization Programs: Empowerment Zones, Enterprise Communities and Renewal Communities*, GAO-10-464R, March 2010.

[253] *Ibid.*, p. 24.

[254] *Ibid.*, p. 24.

[255] *Ibid.*, p. 36.

[256] *Ibid.*, p. 26.

aggregate data from Form 1040 (individual) and Form 1120 (corporation) returns indicating $675 million and $2.6 billion, respectively, in employment credits for processing years 1997 through 2008. While these employment credits are specific to revitalization programs, the credits cannot be tied to any one zone or community.

GAO concluded that while "in many cases economic conditions improved in communities…it has been difficult to isolate the impacts of these programs on conditions in distressed communities without the ability to attribute the tax benefits to [specific] areas."[257]

Economic literature analysis

The economic literature assessing the impact of Federal empowerment zones is limited.[258] In general, these studies have found modest affects overall with relatively high costs. Another issue is the difficulty of identifying which aspects of zone designation, grants or tax incentives, may be responsible for any observed increases in economic activity.

One study examined the Federal empowerment zones in Baltimore, Chicago, Detroit, and New York and found that, while poverty and unemployment decrease in some zone areas, similar changes occurred in comparison areas that did not receive the empowerment zone designation, suggesting that changes within zones are consistent with citywide economic trends. Overall the authors found no statistically significant change in income, unemployment, or poverty.[259]

Another study suggests that these overall modest or insignificant effects may mask countervailing effects on different subsets of firms.[260] Increases in employment, sales, and capital expenditures in new and existing establishments may be mostly offset by losses in employment, sales, and capital expenditures among firms that close or leave the zone. The authors note that if this churning of employment improves the desirability of living or locating a

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[257] *Ibid*., p. 44.

[258] A number of studies have examined the effects of similar State programs, most of which preceded the Federal initiatives. See, e.g., Leslie E. Papke, "Tax Policy and Urban Development: Evidence from the Indiana Enterprise Zone Program," *Journal of Public Economics*, 54 (May 1994), pp. 37-49. For a review of the early literature, see Alan. H. Peters and Peter S. Fisher, "State Enterprise Zone Programs: Have They Worked?" Kalamazoo, MI: W.E. Upjohn Institute for Employment Research (2002). For a more recent review, see Joel A. Elvery, "The Impact of Enterprise Zones on Resident Employment," *Economic Development Quarterly*, 23, (February 2009), pp. 44-59. We are unaware of economic literature assessing the impact of the tax benefits under the renewal community program.

[259] Deirdre Oakley and Hui-shien Tsao, "A New Way of Revitalizing Distressed Urban Communities? Assessing the Impact of the Federal Empowerment Zone Program," *Journal of Urban Affairs*, 28 (November 2006), pp. 443-471.

[260] Danielle Bondonio and Robert T. Greenbaum, "Do Local Tax Incentives Affect Economic Growth? What Mean Impacts Miss in the Analysis of Enterprise Zone Policies," *Regional Science and Urban Economics*, 37 (2007), pp. 121-136.

business in an empowerment zone, this benefit may be capitalized into local property values and zone effectiveness may be evaluated by estimating increases in property values.[261]

Other researchers have found significant increases in property values within zones. One study found median home value appreciation in Round I empowerment zones was 25 percent faster than it would have been without the program.[262] The authors suggest that this effect may be a result of improved amenities (such as better services, lower crime, better infrastructure, or better access to employment), a reduction in the supply of low-quality housing, and/or an increase in the demand for commercial real estate to access program benefits, which could drive up the price of residential property.[263]

Another study found that housing values increased by approximately 22 percent while rents increased by approximately seven percent, suggesting an overall increase in housing wealth within the Round I urban zones of approximately $1.2 billion.[264] The authors also found that employment increased four percentage points while unemployment and poverty decreased by similar amounts. This translates into an increase in empowerment zone employment of approximately 30,000, a decrease in unemployment of approximately 13,000 individuals, and a decrease in the poverty headcount of around 50,000 individuals.

One critique noted that previously employed renters within an empowerment zone may be financially worse off as rents rise while earnings do not.[265] The authors also pointed out that the cost of empowerment zone incentives per year per job created is likely relatively high. They suggest that place-based initiatives can be justified only if the targeted areas exhibit stronger economies of scale in production and consumption than other areas, the evidence of which is absent, and that a more effective approach is to reconsider policies that require local businesses and workers to pay for local redistribution and to limit land use restrictions in high-income, high-productivity areas.

Prior Action

No prior action.

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[261] *Ibid.,* p. 133.

[262] Douglas J. Krupka and Douglas S. Noonan, "Empowerment Zones, Neighborhood Change and Owner-Occupied Housing," *Regional Science and Urban Economics*, 39 (2009), pp. 386-396.

[263] These outcomes may result from pledges made in the empowerment zone application process to spend funds on police and infrastructure.

[264] Matias Busso and Patrick Kline, "Do Local Economic Development Programs Work? Evidence from the Federal Empowerment Zone Program," Cowles Foundation Discussion Paper No. 1638; Yale Economics Department Working Paper No. 36 (February 2008).

[265] Edward L. Glaeser and Joshua D. Gottlieb, "The Economics of Place-Making Policies," *Brookings Papers on Economic Activity* (2008), No. 1, pp. 155-239.

F. Restructure Transportation Infrastructure Assistance to New York City

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[266] The availability of most of these incentives for new investment activity has expired. The longest-lived incentive, a special depreciation allowance for qualified NYLZ property, is not available for property placed in service after December 31, 2011.

Description of Proposal

The proposal provides Federal tax credits to New York State and New York City for expenditures relating to construction or improvement of transportation infrastructure in or connecting to the NYLZ. The tax credits are allowed in each year from 2012 through 2021, inclusive, and are subject to an annual limit of $200 million, for a total of $2 billion in tax credits. They are divided evenly between New York State and New York City. Any amount of unused credit below the $200 million annual limit is carried forward to the following year, including years after 2021, and expenditures that exceed the $200 million annual limit are carried forward and subtracted from the $200 million annual limit in the following year.

The credits are allowable against any payment by the State or City to the Federal government required under a provision of the Internal Revenue Code other than the provisions relating to payments of excise taxes, FICA, SECA, or OASDI amounts. For example, the credits are allowable against payments of Federal income tax withheld with respect to State or City employees.

Treasury is authorized to prescribe guidance to ensure that the expenditures satisfy the intended purposes. The amount of the credit will be treated as State and local funds for purposes of any Federal program.

Effective date.−The proposal is effective on January 1, 2012.

Analysis

The proposal is based on the premise that some of the tax benefits provided by the NYLZ incentive provisions were not usable in the form in which they were originally provided, and that

[266] In addition to the NYLZ provisions described above, the following NYLZ provisions expired in 2006: five-year recovery period for depreciation of certain leasehold improvements, increase in expensing under section 179, and extended replacement period for nonrecognition of gain under section 1033.

they should be succeeded by other benefits that would have a greater impact on the recovery and continued development in the NYLZ. The proposal reflects a preference for subsidizing transportation infrastructure as opposed to buildings and other private property.

The proposal could be criticized as disguising a Federal transportation infrastructure subsidy to New York State and New York City in the form of a tax credit. Providing a transportation infrastructure subsidy as a direct grant outside of the tax law would be more consistent with simplification of the tax law and administrative efficiency.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, 2008, 2009, 2010, and 2011 budget proposals. These prior proposals included the repeal of certain other NYLZ incentives not previously expired.

PART IV − CONTINUE CERTAIN EXPIRING PROVISIONS THROUGH CALENDAR YEAR 2012

A number of temporary tax provisions that had been routinely extended have expired or are scheduled to expire on or before December 31, 2011. The Administration proposes to extend a number of these provisions through December 31, 2012.

For estimates of the provisions that the Administration proposes to extend see Part VI of the table in the Appendix: March 2011 Estimates of the Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal.

PART V − OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS

A. Reform Treatment of Financial Institutions and Products

1. Impose a financial crisis responsibility fee

In response to the recent financial crisis, the Federal government made stabilizing investments in many financial institutions through the Troubled Asset Relief Program ("TARP"), pursuant to the Emergency Economic Stabilization Act of 2008 ("EESA").[267] In connection with these investments, and in anticipation of a potential obligation under EESA,[268] the Administration proposes a financial crisis responsibility fee. Under present law, there is no sector-specific Federal tax applicable to financial institutions.

Present Law

Corporations generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[269] generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Corporations that make a valid election pursuant to section 1362 of Subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items upon a subsequent disposition of S corporation stock, each

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[267] The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, established the Office of Financial Stability within the Department of the Treasury to implement TARP. For a detailed description of the various TARP programs see Government Accountability Office, *Financial Audit - Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, December 2009, GAO-10-301, pp. 45-65.

[268] EESA provides that on October 4, 2013, the Director of the Office of Management and Budget, in consultation with the Congressional Budget Office, shall submit to Congress a report on the net amount within the TARP. The statute requires that in any case where there is a shortfall, "the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall." 12 U.S.C. sec. 5239.

[269] Corporations subject to tax are commonly referred to as C corporations after Subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (Real Estate Investment Trusts) or in stock and securities (Regulated Investment Companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to Subchapter C.

shareholder's basis in such stock is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

To qualify for S corporation status, a corporation must be a small business corporation as defined in section 1361(b)(1) and not be an ineligible corporation as defined in section 1361(b)(2). A corporation qualifies as a small business corporation if it has 100 or fewer shareholders, has only individuals or certain trusts and estates as shareholders, has no nonresident aliens as shareholders, and has only one class of stock. Ineligible corporations include any financial institution using the reserve method of accounting for bad debts (discussed below) and any insurance company subject to Subchapter L of the Code.

Banks, Thrifts, and Credit Unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with certain specified exceptions. There is no sector-specific Federal income tax currently applied to financial institutions, and there are currently no corporate taxes assessed on the balance sheet liabilities of an entity.

Certain special rules and exceptions that are applicable to determining the Federal income tax liability of banks and thrifts, certain other financial institutions, insurance companies, and broker dealers are discussed below.

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[270] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[271] Prior to 1951, thrifts were exempt from Federal taxation. In 1951, mutual savings banks and savings and loan associations lost their tax exemption because they were viewed as being "in active competition with commercial banks and life insurance companies for the public savings."[272]

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[270] Sec. 581.

[271] See Treas. Reg. sec. 1.581-1 ("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank…there are certain exceptions and special rules [for such institutions]").

[272] S. Rep. No. 82-781, Revenue Act of 1951, p. 25.

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.[273]

Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. For taxable years beginning before 1987, section 166(c) allowed taxpayers to deduct annual reasonable additions to a reserve established for bad debts (in lieu of deducting specific debts as worthless in the year in which the bank determined the debt was worthless). The reserve method of accounting for bad debts was repealed in 1986[274] for most taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

Prior to 1996, thrifts (mutual savings banks, domestic savings and loan associations, and cooperative banks) had separate bad debt reserve rules under section 593. The special rules for thrifts were repealed for tax years beginning on or after January 1, 1996.[275]

Credit unions

Credit unions are exempt from Federal income taxation.[276] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater utilization of credit unions.[277] While

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[273] Sec. 1361(b)(2).

[274] Tax Reform Act of 1986, Pub. L. No. 99-514.

[275] The Small Business and Job Protection Act of 1996, Pub. L. No. 104-188.

[276] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070.htm.

[277] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple-common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.,* 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[278]

Gains and losses with respect to securities held by financial institutions

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. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain of a corporation is currently taxed at a rate not to exceed 35 percent, which is also the maximum corporate income tax rate. 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.

Capital losses generally are deductible in full against capital gains. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges. Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income. However, in general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year.

In the case of an S corporation, net capital losses flow through to the corporation's shareholders and could be considered losses attributable to a banking business in such shareholders' hands. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the assets, liabilities, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year attributable to that banking business. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

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[278] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070.htm.

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.

Under section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. Thus, generally, as a manufacturer receives ordinary income treatment on sale of its inventory, so does a financial institution on the sale or exchange of its loans under section 582. A financial institution described in section 582(c)(2) includes: (1) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation); (2) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law; (3) any small business investment company operating under the Small Business Investment Act of 1958; and (4) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Stock (including preferred stock) is not considered indebtedness for tax purposes and therefore is not treated as an asset entitled to ordinary gain or loss treatment under section 582.[279] However, under section 301 of Division A of the Emergency Economic Stabilization Act of 2008,[280] gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company, as defined in the Federal Deposit Insurance Act.[281] Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (1) held by the

[279] Under section 306 of the Code, the sale of certain preferred stock can produce ordinary income to any taxpayer (without regard to section 582).

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

applicable financial institution on September 6, 2008, or (2) sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[282]

Insurance companies

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Generally, an insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[283] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

A life insurance company is subject to tax on its life insurance company taxable income.[284] Life insurance company taxable income is the sum of premiums and other consideration on insurance and annuity contracts, decreases in certain reserves, and other amounts includible in gross income, reduced by allowable deductions for all claims and benefits accrued and all losses incurred during the taxable year, increases in certain reserves, policyholder dividends, dividends received, operations losses, certain reinsurance payments, and other deductions allowable for purposes of computing taxable income.[285]

The taxable income of a property and casualty insurance company is the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[286] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Certain special rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance

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[281] 12 U.S.C. 1813(w)(1).

[282] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9 percent of the common stock of such companies.

[283] Sec. 816.

[284] Sec. 801.

[285] Secs. 801-818.

[286] Sec. 832.

agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[287]

Broker-dealers

For Federal income tax purposes, a person generally is a securities dealer if such person regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[288] The determination of dealer status is made based on all facts and circumstances. The courts and the IRS have considered the following factors in evaluating dealer status: (1) being licensed as a dealer;[289] (2) holding oneself out to the public as a dealer;[290] (3) selling inventoried securities to customers;[291] (4) the frequency, extent, and regularity of securities transactions;[292] (5) profiting from commissions as opposed to appreciation in the value of securities;[293] and (6) ownership of a securities exchange membership.[294]

Securities dealers must account for their securities inventory using the mark-to-market accounting method.[295] In general, under that method, securities held by a dealer in its inventory are marked to fair market value at the close of the taxable year, with any resulting difference between value and basis included as ordinary income or loss in computing taxable income for such year. For this purpose a security is defined as any share of stock in a corporation, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, interest rate, currency, or equity notional principal contract, and evidence of an interest in, or a derivative financial instrument in any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.[296] Additionally, a security

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[287] Secs. 841-848.

[288] Sec. 475(c)(1) (defining a securities dealer for purposes of section 475); c.f., Treas. Reg. sec. 1.864-2(c)(2)(iv) (defining a dealer in stock or securities for purposes of the trader safe harbors to section 864) and Treas. Reg. sec. 1.471-5 (as amended in 1993).

[289] *Polachek v. Commissioner,* 22 T.C. 858, 859 (1954).

[290] *Verito v. Commissioner,* 43 T.C. 429, 441-442 (1965), acq. 1965-2 C.B. 7.

[291] *United States v. Chinook Investment Co.,* 136 F.2d 984 (9th Cir. 1943).

[292] *Purvis v. Commissioner,* 530 F.2d 1332, 1334 (9th Cir. 1976).

[293] *Kemon v. Commissioner*, 16 T.C. 1026, 1033 (1951).

[294] *Securities Allied Corp. v. Commissioner*, 95 F.2d 284, 286 (2d Cir. 1938), aff'g 36 B.T.A 168 (1937), cert denied, 305 U.S. 617 (1938).

[295] Sec. 475.

[296] Sec. 475(c)(2). The definition of securities under section 475 excludes sec. 1256 contracts, which include futures contracts and certain exchange-traded options.

includes a position that is not one of the foregoing, but is a hedge with respect to such security, and is clearly identified in the dealer's records as a security before the close of the day on which it was acquired.[297]

Special rules apply to gains and losses of a securities dealer with respect to "section 1256 contracts."[298] Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.[299] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[300]

A securities dealer may also hold securities for investment rather than as inventory (such securities are not subject to mark-to-market accounting, and any gains or losses with respect thereto treated as capital rather than ordinary).[301] Additionally, a dealer is not subject to mark-to-market accounting for debt securities originated or entered into in the ordinary course of its trade or business that are not held for sale.[302] For either of these exceptions to apply, the dealer must clearly identify that the security is either held for investment or not held for sale by the close of the day the security is acquired and the security may not at any time thereafter be held primarily for sale to customers.[303]

Description of Proposal

The proposal imposes an annual financial crisis responsibility fee based on certain liabilities of U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control certain broker-dealers and insured depository institutions, as well as on U.S. companies owning or controlling such entities as of January 14, 2010. The proposed rate has not been determined, but is expected to be approximately 0.075 percent of an applicable

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[297] Sec. 475(c)(2)(F).

[298] Section 1256(b) provides that a "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract; (3) nonequity option, (4) dealer equity option; and (5) dealer securities futures contract, but does not include any securities future contract or option on such contract unless such contract or option is a dealer securities future contract, or any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap , or similar agreement.

[299] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

[300] Sec. 1256(c)(1). Additionally, section 1212(c) provides that a taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.

[301] Secs. 1236 and 475(b)(1).

[302] Sec. 475(b)(1).

[303] Secs. 1236(a) and (d)(1). See also section 475(b)(2).

financial firm's covered liabilities. An unspecified discount applies to certain sources of funding considered more stable, including long-term liabilities. Covered liabilities are generally defined as consolidated risk-weighted assets, less capital, deposits subject to assessments by the Federal Deposit Insurance Corporation (the "FDIC") (in the case of banks), certain insurance policy-related liabilities and other (unspecified) policy holder obligations (in the case of insurance companies) and certain loans to small businesses. Adjustments would be provided to prevent avoidance of the fee. The fee only applies to firms with worldwide consolidated assets of $50 billion or more. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below the threshold. United States subsidiaries of foreign firms that fall into these categories and that have assets of $50 billion or more also would be subject to the fee.[304]

The fee is reported on a firm's Federal income tax return and is deductible in computing corporate income tax. The fee is payable through payments on the same schedule as estimated income tax payments.

Effective date.−The proposal is effective as of the day after December 31, 2012.

Analysis

Significant details of the Administration's proposal are unclear, including the firms subject to the fee, the intended fee base, and the fee rate. The uncertainty in the proposal makes it difficult to evaluate the proposal's technical details. The following discussion, therefore, also highlights issues in need of further consideration.

Covered institutions

The universe of institutions subject to the proposed financial crisis responsibility fee is not entirely clear from the proposal. For example, the proposal applies to "certain broker-dealers" and companies that control "certain broker-dealers" but does not specify criteria for inclusion or exclusion.[305] Prior financial crisis responsibility fee proposals suggested both that an insurance company was a covered institution only if it owned a bank or broker or securities dealer as of January 14, 2010,[306] or if it owned a bank or broker or securities dealer as of that

[304] The proposal states that U.S. subsidiaries of foreign firms with "assets in excess of $50 billion also would be covered," but the threshold for U.S.-based institutions is assets of $50 billion or more. This analysis assumes the threshold is intended to be the same for both.

[305] Treasury Secretary Geithner noted in testimony before the Senate Finance Committee on May 4, 2010, that the reference to broker-dealers was meant to refer to "primary dealers…eligible for the Federal Reserve's primary dealer facility…"

[306] See, e.g., U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 29 ("The fee would be applied to banks, thrifts, bank and thrift holding companies, brokers, and securities dealers [and] U.S. companies owning or controlling these types of entities as of January 14, 2010…").

date or any time later.[307] The current proposal can be read to mean that the fee may apply to an insurance company only if it currently controls a (specified) broker-dealer, or if it owned such a broker-dealer or an insured depository institution as of January 14, 2010.

Some may argue it is arbitrary to apply the fee to a company that happens to have had a small bank subsidiary as of January 14, 2010, but to exempt an otherwise similarly situated insurance company that did not have a bank subsidiary as of that date, or to exempt an insurance company with less than $50 billion in assets but with a larger banking subsidiary than an insurance company with assets exceeding $50 billion. In response, others may argue that the fee is intended to apply to the largest, most systemically significant entities that were eligible to receive benefits pursuant to the TARP, whether or not they actually received TARP funds. Thus, the argument goes, insurance companies that owned a thrift, or acquired one in order to qualify for TARP benefits, are properly subject to the fee. In addition, it is also possible that defining a covered institution as any company owning certain broker-dealers or insured depository institutions as of January 14, 2010 could subject unintended entities to the fee. For example, unless otherwise exempted, mutual fund groups owning captive securities broker-dealers to service fund trading requirements could be subject to the fee.[308]

Another ambiguity is presented by the $50 billion worldwide consolidated asset threshold. The fee applies to U.S.-based firms with $50 billion or more in worldwide consolidated assets and would not apply to otherwise eligible entities for the period when their assets are below this threshold. It is not clear what is intended by "consolidated." The meaning of, and requirements for, consolidation differs in the financial reporting and U.S. Federal income tax contexts.[309] The proposal can be read to mean that the relevant amount is what is actually reported to the appropriate Federal or State regulators. However, the proposal can also be read to suggest such reported amounts are a noncontrolling guide. In addition, application of the threshold is not clear in the case of foreign-based institutions. There are at least three options for a group with a foreign-based parent: (1) the threshold applies on a worldwide consolidated basis regardless of whether the ultimate parent entity is U.S. or foreign-based; (2) the consolidated assets of all U.S.-parented groups under an ultimate foreign parent are aggregated;[310] or (3) the

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[307] See, e.g., Administration's January 14, 2010 announcement of a proposed financial crisis responsibility fee, available at http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn and http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf ("Covered institutions would include firms that were insured depository institutions, bank holding companies, thrift holding companies, insurance or other companies that owned insured depository institutions, or securities broker-dealers as of January 14, 2010, or that became one of these types of firms after January 14, 2010").

[308] It may be intended that such mutual fund broker-dealers are not one of the "certain" types of broker-dealers referenced by the proposal. See Treasury Secretary Geithner's testimony before the Senate Finance Committee, *supra*, n. 305.

[309] In addition, there is potential for technical difficulty in measuring the worldwide assets of a foreign-based firm that may not otherwise be subject, or is subject only to a limited extent, to U.S. Generally Accepted Accounting Principles or U.S. tax standards.

[310] This could, for example, aggregate two separate brother-sister consolidated U.S. groups under a single foreign parent.

threshold applies to each U.S.-parented group's assets on a stand-alone basis. The best reading of the proposal may be the third and narrowest option as the proposal specifically looks to the "assets" of U.S. subsidiaries and not the "consolidated" or "aggregate consolidated" assets of such subsidiaries.

Some may argue that the $50 billion in worldwide consolidated assets threshold establishes an arbitrary line. Opponents may note that a bright line threshold can alter the behavior of taxpayers operating near the threshold.

Fee base

Under the Administration's proposal, the fee applies to the "risk-weighted assets" of covered firms, less certain amounts.[311] The current risk-weighting standards employed in the United States are in flux, the ultimate resolution of which is not clear.

U.S. bank regulatory capital requirement standards are generally based on accords promulgated by the Basel Committee on Banking Supervision of the Bank of International Settlements (the "Basel Accords"), the guiding principle of which is that capital standards should be risk-based. As outlined in more detail below, banks are generally required to hold some minimum level of capital (e.g., three percent of adjusted total assets) and satisfy a minimum risk-based capital ratio (e.g., a ratio of capital to total risk-weighted assets of eight percent). In effect, the Basel Accords attempt to measure bank capital relative to an institution's risk profile, and riskier assets require an institution to hold more to absorb potential losses. There have been three Basel Accords commonly referred to as Basel I[312] (adopted in 1988), Basel II[313] (announced in 2004) and Basel III[314] (final rules published in December 2010). As agreements reached between various central banks and bank supervisory authorities, the Basel Accords are not legally binding, and member countries may modify the agreements.

The current U.S. bank regulatory capital requirements are generally based on Basel I, with the exception that certain very large financial institutions are in the process of transitioning to a revised standard developed in connection with Basel II. Because there are multiple financial institution regulators in the United States, each of which separately defines its scheme for risk-weighting assets, specific capital requirements are subject to minor variation among the Office of

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[311] Notably, the base of the fee references *consolidated* risk-weighted assets and not, like the threshold, a *worldwide consolidated* figure. It is unclear whether this means that for a U.S.-based firm with foreign subsidiaries that the base of the tax may be narrower than the assets counted for purposes of qualifying as a covered institution.

[312] Basel Committee: *International Convergence of Capital Measurement and Capital Standards*, available (with updates) at http://www.bis.org/list/bcbs/sac_1/tid_21/index.htm.

[313] *Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, available (with updates) at http://www.bis.org/publ/bcbs107.htm.

[314] *Basel III: A global regulatory framework for more resilient banks and banking systems* and *Basel III: International framework for liquidity risk measurement, standards and monitoring* available at http://www.bis.org/list/basel3/index.htm.

the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Federal Reserve, the Office of Thrift Supervision (the "OTS")[315] and the National Credit Union Administration (the "NCUA"). However, the OCC, the Board of Governors of the Federal Reserve System, the FDIC and OTS must jointly submit an annual report to the Committee on Financial Services of the U.S. House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate describing differences between the accounting and capital standards used by and among the agencies.[316]

Basel I, as currently implemented in the United States, attempts to measure capital relative to an institution's risk profile by adjusting each asset (both on-balance sheet and certain off-balance sheet assets first converted to an on-balance sheet equivalent amount) relative to its risk. Specifically, an institution's risk-weighted assets are calculated by assigning a bank's assets to one of four risk categories: 0 percent, 20 percent, 50 percent, and 100 percent. The least risky assets (e.g., AAA-rated sovereign debt and cash) are assigned a risk weight of 0 percent, while the most risky assets (e.g., commercial loans) are assigned a risk weight of 100 percent. Thus, for example, the amount of capital required to be held against $10,000 of U.S. Treasury bills is $10,000 * 0.08 * 0 = $0. In contrast, a $10,000 loan to a private business receives a risk-weighting of 100 percent, requiring an amount equal to eight percent of the value of the asset (in this case $800 = $10,000 * (0.08 * 1.00)) to be held as capital against it.

In December 2007, Federal banking regulators issued a final rule for implementation of the Basel II Capital Accord in the United States.[317] Basel II offers three approaches for measuring capital adequacy for capital risk: (1) the standardized approach, which is similar to the Basel I category approach; (2) the foundational internal ratings-based approach; and (3) the advanced internal ratings-based approach ("A-IRB").[318] Under the Basel II A-IRB risk-weighting scheme, the Basel I risk categories are replaced with a formula approach. Generally, a bank subject to the A-IRB approach determines four basic inputs ("risk components") based (in some cases) on its own quantitative models (subject to minimum standards and regulatory supervision) for each balance sheet asset. The bank estimates (1) the probability of default with respect to the asset; (2) the expected loss should there be a default; (3) the amount of risk in the event of default; and (4) the maturity of the asset.[319] These four inputs, along with other factors,

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[315] The Office of Thrift Supervision is to be dissolved pursuant to sections 311-327 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203).

[316] See, e.g., *Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies; Report to Congressional Committees*, 75 FR 47900 (August 9, 2010).

[317] *Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II*, 72 FR 69288-01. Because the relevant agencies jointly adopted the new rulemaking, there are no differences among the agencies' Basel II rules.

[318] For a more complete description of these approaches, see CRS Report RL33278, *The Basel Accords: The Implementation of II and the Modification of I*, by Walter W. Eubanks.

[319] These inputs are commonly referred to as PD (probability of default), LGD (liability given default), EAD (exposure at default), and M (maturity). Not all risk components are relevant for every risk-weight function.

are plugged into the appropriate risk-weight function, the means by which risk components are transformed into risk-weighted assets and therefore capital requirements. Different exposures have different risk-weight functions. For example, there are separate risk-weight functions for corporate exposures and for qualifying revolving retail exposures. Thus, the risk weight under the Basel II A-IRB is, generally, a function of individually determined inputs with respect to each asset of an asset class and not a static system of risk-weighting categories.

In the United States, banks or bank holding companies with at least $250 billion in consolidated total assets, or at least $10 billion of on-balance sheet foreign exposure are generally subject to Basel II's advanced internal ratings-based approach.[320] All other banks have the option to remain under the Basel I framework. As of February 2011, the Basel II framework applied on a mandatory basis to approximately 18 U.S. bank holding companies holding approximately 70 percent of assets in the U.S. banking system.[321] While a number of these institutions are currently developing systems for, or are in, a parallel run period (that is, operating and reporting under the current Basel I standard, but simultaneously calculating and testing Basel II systems), complete operational implementation of Basel II has not yet been achieved.

In response to the recent global financial crisis, the Basel Committee on Banking Supervision developed and promulgated Basel III[322] and Congress enacted The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[323] Some aspects of Dodd-Frank are inconsistent with Basel III while other provisions require changes to the Basel II A-IRB risk-weighting scheme.[324] For example, Dodd-Frank section 171(b)(2) requires U.S. regulatory agencies to establish minimum risk-based capital requirements for insured depository institutions, depository institution holding companies and nonbank financial companies that are not quantitatively less than "generally applicable" capital requirements. Implementation of the A-IRB rules discussed above included transitional floors which would limit, temporarily, the amount by which a banking organization's risk-based capital requirements could decline relative to the general Basel I rules over a period of at least three years following completion of a parallel run.[325] Because these transition rules, and the Basel II framework more generally, allow for the

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[320] 72 FR 69288-01.

[321] See, e.g., the United States' response to the Financial Stability Board Implementation Monitoring Network survey available at http://www.financialstabilityboard.org/publications/r_101111b.htm.

[322] On December 16, 2010, Basel Committee on Banking Supervision released *Basel III: A global regulatory framework for more resilient banks and banking systems* and *Basel III: International framework for liquidity risk measurement, standards and monitoring*, available at http://www.bis.org/list/basel3/index.htm.

[323] Pub. L. No. 111-203.

[324] See, e.g., Congressional Research Service, *The Status of the Basel III Capital Adequacy Accord* (R41467), October 28, 2010, by Walter W. Eubanks; and *Risk-Based Capital Standards: Advanced Capital Adequacy Framework-Basel II; Establishment of a Risk-Based Capital Floor*, 75 FR 82317 (December 30, 2010).

[325] See 75 FR 82317.

possibility of a capital requirement lower than would be required if calculated using the Basel I rules, the rules must be amended to comply with Dodd-Frank.[326]

Because U.S. capital adequacy standards are in flux, it is possible for the proposed financial crisis responsibility fee base to shift, perhaps significantly. Although the United States has committed to implement Basel III through national regulations by the end of 2012,[327] the new accord builds upon the framework of Basel II which the U.S. is transitioning to operationally implement. And although Dodd-Frank sets a floor for the risk-weighting of assets which is not a part of Basel III, it is not yet clear how Basel III risk-weighting calculations will differ for those very large banks ultimately required to use the advanced ratings approach. It is possible, for example, that the fee base will differ for institutions with assets between $50 and $250 billion and those with assets of $250 billion or more.

A second component of calculating the fee base is also affected by the move to Basel III and the passage of Dodd-Frank because covered liabilities are determined as a function of both risk weighted assets and capital. In addition to changes in the risk-weighting of certain asset classes, the move from Basel II to Basel III involves enhanced minimum capital requirements. For example, although the overall minimum capital ratio remains at eight percent, the new accord calls for the phase-in of a capital conservation buffer equal to 2.5 percent of risk-weighted assets outside periods of financial stress. In addition, the new accord contemplates an additional countercyclical buffer which would further increase capital requirements when national banking authorities judge there to be excess aggregate credit growth associated with a build-up of system wide risk.[328] The timing and amount of such an additional buffer is left to the discretion of the relevant national authorities.

Although financial institutions subject to the fee may be required to calculate risk-weighted assets using different standards, the Dodd-Frank risk-weighted asset floor for large banks insures that the largest banks will not have an advantage over smaller banks merely by using a different method. Some may argue that establishing a risk-weighted asset floor is appropriate for larger banks more likely to be systematically important. Proponents of the fee may note that as higher capital requirements are phased-in, the fee base (and thus fee payable) may correlatively decrease. However, because the countercyclical buffer is intended to apply during periods of expansion preceding a crisis, its addition may have the effect of decreasing the fee base at a time when institutions are most profitable. For the largest banks, however, this correlation is difficult to gauge since risk-weighting is done on an individualized basis. As probabilities of default and liability in the event of default increase, the fee base could also increase resulting in a larger fee during times of financial distress, potentially compounding such distress.

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[326] *Ibid*.

[327] See, e.g., the United States' response to the Financial Stability Board Implementation Monitoring Network survey available at http://www.financialstabilityboard.org/publications/r_101111b.htm.

[328] Basel III, *supra* note 314, p. 57.

Another uncertainty is how risk-weighted asset figures will be calculated and reported for entities not currently subject to such requirements. For instance, it is possible that entities not subject to current bank and bank holding company capital requirements (e.g., insurance companies, mutual funds, certain broker-dealers) will be subject to the fee and therefore required to calculate risk-weighted assets. It is not clear to whom these entities would be required to report such a number, who would review such calculations, and how long such entities would be given to develop systems to calculate the figure. Moreover, it is possible that non-bank institutions and their supervisors will have to risk-weight specific exposures not typically held by banking institutions which do have a specific risk weight under the applicable guidelines.[329] Under the Basel I framework, the 100 percent risk weight category is a catch all for non-specified exposures, but automatically risk weighting unspecified exposures could either overstate or understate risk, and thus arbitrarily increase or decrease the fee due.[330] Apart from the calculation uncertainty, some might argue that the risk weighting scheme as applied in the banking industry is generally ill-suited to other industries – for example, the fundamental business models and risks faced by depository institutions and insurance companies differ. In addition, insurance companies are subject to separate capital adequacy and solvency regulation.

The proposal contemplates certain adjustments to the financial crisis responsibility fee base, including exclusions for "certain policy-related liabilities" and policy holder obligations (in the case of insurance companies) and certain loans to "small business." It is not clear from the proposal which policy-related liabilities or obligations would be excluded, or the method for determining exclusion. Similarly, it is not clear what constitutes a "small business" for purposes of exclusion. Notably, the Code does not employ a consistent measure of "small" for purposes of defining a small business, but generally looks to attributes of the business.[331] In the banking context, "small" may be measured relative to the size of the loan. For example, under banking regulations loans to small businesses consist of commercial and industrial loans, or loans secured by nonfarm residential properties, with original amounts of $1 million or less.[332]

Depending on the composition of a covered institution's balance sheet and any provided adjustments, it is possible for the base of the fee to be negative. It is unclear what happens under these circumstances.

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[329] See, e.g., 75 FR at pp. 82319 to 82321.

[330] For large institutions on the Basel A-IRB risk weighting scheme this issue presents itself both in calculation of the Dodd-Frank imposed floor and potentially in calculating the risk-weight.

[331] The Code uses various measures for identifying a "small" business including assets (e.g., sec. 1202 (exclusion of capital gain on small business stock)), gross receipts (e.g., sec. 38 (eligible small business credits), sec. 55 (AMT exemption for small corporations)), number of employees (e.g., sec. 41 (eligible small business contract research), sec. 45E (small employer pension start-up costs)) and production or capacity (e.g., sec. 40(b)(4) (small ethanol producer credit), sec. 40A(b)(5) (small agri-biodiesel fuel producer credit)).

[332] See, e.g., 12 C.F.R. sec. 304.3 and *Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and FFIEC)* available at: http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_FFIEC041_201103_i.pdf.

Rate of fee

The rate of the financial crisis responsibility fee is described as "approximately" 7.5 basis points (0.075 percent) with a discount for certain stable sources of funding, including long-term liabilities. It is not clear what else might constitute a stable source of funding, how much of a discount would be applied, or how such discount would be applied in calculating the fee.

General policy concerns

One rationale for the financial crisis responsibility fee is that it would provide a deterrent against excessive, and potentially risky, leverage and assets for the largest firms. Risk in this context has various meanings.[333] Financial institutions face systemic risk commonly described as risk an institution faces as a market participant against which it cannot diversify. Financial institutions may also contribute to systemic risk, that is, risk that the linkages between institutions in the financial system might affect the economy as a whole. Various risks may also be identified on both sides of a financial institution's balance sheet. On the asset side, each originated or held loan involves credit risk (whether the borrower pays) and interest rate risk (generally, when interest rates increase and the value of the loan drops, or rates decrease and borrowers accelerate their repayments).

With respect to the liabilities side of the balance sheet, liquidity risk includes the sudden withdrawal or unavailability of funds. A financial institution commonly faces varying degrees of durational risk, that is, a mismatch in the terms and timing of cash flows of its assets and its obligations. For example, banks typically raise money for long-term loans, such as 30-year residential mortgages, by borrowing short-term from depositors who can withdraw their money at any time. Thus, a sudden withdrawal of capital (e.g., a run on a bank) could result in an insolvent bank regardless of the quality of its assets if such assets cannot be liquidated quickly enough. A nondepository institution that relies on other forms of short-term capital with long-term assets faces a similar risk. Managing these risks is the principal business of financial intermediaries, and for which investors in these institutions are compensated. As discussed above, bank regulatory capital requirements are generally intended to address these solvency risks.

It could be argued that the Administration's proposal contributes to the stability of the financial system to the extent it provides a disincentive to raise funds using certain types of risky debt and by providing a disincentive to invest in riskier assets. Regarding liabilities, critics might counter that the proposal, in effect, imposes a fee on all leverage other than insured deposits (or certain policy reserve related assets) which may or may not be particularly risky or even possible to avoid. For example, general trade liabilities such as accounts payable would be subject to the fee. Regarding assets, critics might note that the proposal attempts to exempt a

[333] See, e.g., Congressional Research Service, *Who Regulates Whom? An Overview of U.S. Financial Supervision (R40249)*, December 14, 2009, by M. Jickling and E. Murphy, available at http://www.crs.gov/ReportPDF/R40249.pdf.

relatively risky asset, the small business loan, from the calculation while subjecting other risky assets to the fee.[334]

Some might contend that a fee measured as a fixed percentage of assets or liabilities may actually encourage institutions to undertake riskier investments in pursuit of higher returns to offset the cost of the fee. However, one can counter that those higher risk and higher return investments were also available in the absence of the fee. Having rejected a higher risk/higher return portfolio when its costs were lower, it is not clear why a profit maximizing firm would choose such a portfolio in the face of the fee. On the other hand, if the fee increased the likelihood that the firm would become insolvent given its current investment choices, a firm may be willing to increase the risk of its portfolio in pursuit of higher returns to stave off bankruptcy.

Prior Action

A similar proposal was included in the Administration's fiscal year 2011 budget proposal.

2. Require accrual of the time-value element on forward sale of corporate stock

Present Law

A corporation generally recognizes no gain or loss on the receipt of money or other property in exchange for its own stock (including treasury stock).[335] Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued. In addition, no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

In general, a forward contract means a contract to deliver at a set future date (the "settlement date") a substantially fixed amount of property (such as stock) for a substantially fixed price. Gains or losses from forward contracts generally are not taxed until the forward contract is closed. A corporation does not recognize gain or loss with respect to a forward contract for the sale of its own stock. A corporation does, however, recognize interest income upon the current sale of its stock for a deferred payment.

With respect to certain "conversion transactions" (transactions generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the

[334] Under the Basel I framework, small business loans would generally fall within the 100 percent category with the result that 100 percent of the loan amount would be included in a bank's risk-weighted assets and 100 percent would be subtracted, exempting the loan. If, however, under the Basel II A-IRB method a small business loan were risk-weighted at more than 100 percent the amount of the liability, subtracting the full amount of the loan would not fully exempt the loan. However, disregarding such a small business loan in calculating risk-weighted assets would result in a greater reduction in risk-weighted assets than the amount lent to the small business.

[335] Sec. 1032.

transaction), gain recognized that would otherwise be treated as capital gain may be recharacterized as ordinary income.[336]

Description of Proposal

The proposal requires a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received with respect to the forward contract as a payment of interest.

Effective date.−The proposal is effective for forward contracts entered into after December 31, 2011.

Analysis

Under a traditional forward contract, the purchase price generally is determined by reference to the value of the underlying property on the contract date and is adjusted (1) upward to reflect a time value of money component to the seller for the deferred payment (i.e., for holding the property) from the contract date until the settlement date and (2) downward to reflect the current yield on the property that will remain with the seller until the settlement date.

Strategies have been developed whereby a corporation can obtain favorable tax results through entering into a forward sale of its own stock, which results could not be achieved if the corporation merely sold its stock for a deferred payment. One such strategy that might be used to increase a corporation's interest deductions could involve a corporation borrowing funds (producing an interest deduction) to repurchase its own stock, which it immediately sells in a forward contract at a price equal to the principal and interest on the debt for settlement on the date that the debt matures. Taxpayers may be taking the position that the interest on the debt is deductible, while the gain and loss from the forward contract (including any interest component) is not taxable to the corporation. Although the leveraged purchase illustrates the problem, the borrowing is not necessary to achieve the tax benefits. A corporation could simply use excess cash (which otherwise would be earning a taxable return) to purchase its own outstanding stock and contemporaneously enter into a forward contract to sell the same amount of its stock at a price that reflects a return that is substantially based on the time value of money.[337] In either case, the corporation arguably has achieved a tax-free return on investment.

Advocates of the proposal argue that there is little substantive difference between a corporation's current sale of its own stock for deferred payment (upon which the corporate issuer

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[336] Sec. 1258.

[337] For example, suppose the prevailing interest rate is five percent. A corporation that has $1,000 cash can lend the money to a third party for a year and earn a taxable return $50. If the corporation instead used the money to purchase $1,000 of its own stock and then immediately entered into a forward contract to sell the same amount of stock one year later for $1,050 (the forward price assuming a five percent discount rate and no dividend on the stock), it could earn a $50 tax-free return, assuming the gain on the forward sale is not recognized under section 1032.

would accrue interest[338]) and the corporation's forward sale of the same stock. The primary difference between the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, while in a forward sale, the stock is issued on the settlement date. In both cases, a portion of the deferred payment economically compensates the corporation for the time-value element of the deferred payment. Proponents of the proposal argue that these two transactions should be treated the same. Additionally, some would argue that the proposal is a logical extension of the conversion rules of section 1258 (discussed below) which treat as ordinary income the time-value component of the return from certain conversion transactions.

Opponents of the proposal argue that there is, in many cases, a substantive difference between a corporation's forward sale of its stock and a current sale for a deferred payment. Under a forward sale, the stock is not outstanding until it is issued on the settlement date. The purchaser does not actually own stock that it can transfer free of its obligation to make payment under the forward contract. The purchaser has no current dividend rights, voting rights or rights in liquidation. The forward price may reflect expected dividends on the underlying stock, but that price is generally established in advance and actual dividends may vary from expected dividends. The purchaser of stock for a deferred payment, on the other hand, actually owns the stock and the attendant rights thereto. Therefore, the current sale of stock for deferred payment and the forward sale of stock for future delivery may not be equivalent transactions, but the proposal would treat them the same. Conversely, the proposal would treat differently a forward sale of stock and an issuance in the future of stock for the same price on the same date as the settlement date, which in many respects may be viewed as similar transactions.

In addition, any forward sale by its very nature has a time-value component: that feature is not unique to a corporate issuer of its own stock. The time-value component should compensate the holder for its carrying costs with respect to the property. One could argue that if it is appropriate to impute interest on a forward contract, it should be done for all forward contracts and not just forward contracts involving a corporation's own stock. In other words, as a policy matter it may be inappropriate to address forward sales of a corporation's own stock without addressing the broader question of taxation of the time-value component of forward contracts in general.

The conversion rules of section 1258 provide the closest analog under present law to the proposal. There are, however, several important distinctions between section 1258 and the proposal. Unlike the proposal, the conversion rules (1) do not affect the timing of recognition of the ordinary income and (2) apply only to forward contracts that are part of a conversion transaction. In addition, some also might argue that the policy rationale underlying the conversion rules is not present with respect to the issuance of corporate stock because there is no conversion of ordinary income to capital gain. For example, assume a taxpayer buys gold today for $100 and immediately enters into a forward contract to sell that gold in the future for $110 ($10 of which represents the time value of money). Upon closing of the forward sale, the taxpayer (and its shareholders if it is a corporation) would recognize an economic gain of $10.

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[338] See, e.g., sec. 1272 (requiring current inclusion in income of original issue discount).

Absent the conversion rules, the $10 gain on that transaction may be treated as capital gain notwithstanding that substantially all of the taxpayer's return is with respect to the time value of money. The taxpayer is in the economic position of a lender with an expectation of a return from the transaction that is in the nature of interest and with no significant risks other than those typical of a lender. That arguably is not the case (at least with respect to the economic position of the existing shareholders) with respect to a corporation that enters into a forward sale of its own stock (or certainly not all forward sales of a corporation's own stock). A corporation's ownership of its own stock arguably has no economic significance to the corporation or its shareholders. The purchase or issuance by a corporation of its own stock at fair market value does not affect the value of the shareholders' interests in the corporation. The economic gain or loss, if any, to the existing shareholders of the corporation on the forward sale of its stock would depend on the fair market value of the corporation's stock on the settlement date. If the fair market value of the corporation's stock on the settlement date equals the contract price under the forward sale, then there is no economic gain or loss to the corporation or its shareholders. On the other hand, if the forward price does not equal the fair market value, there could be situations in which the corporation suffers an economic loss (because, for example, the value of the stock is greater than the forward price). Even in situations in which there is an economic loss, however, the proposal would tax the corporation on the imputed time-value element.[339]

Some have suggested that a more narrowly tailored solution could be developed to address the perceived abuse of a corporation in essence being able to make a tax-free, fixed-income investment in its own stock (i.e., the "cash and carry transaction"). Under such an approach, the corporation would recognize taxable gain only if it acquired its own stock and on a substantially contemporaneous basis entered into a forward contract to sell its own stock and substantially all of its expected return from the transaction was attributable to the time value of money invested.[340]

Finally, some would argue that the provision narrowly focuses on one type of derivative contract with respect to a corporation's own stock and that a broader approach addressing the treatment under section 1032 of derivative contracts and other techniques for using a corporation's own stock would be more appropriate. Otherwise, the inconsistent treatment of economically equivalent transactions under section 1032 and the uncertainty as to its scope, in particular with respect to its applications to derivative contracts in a corporation's own stock, could result in whipsaw against the government. Those who espouse this view would argue that consideration should be given to a range of alternative approaches for addressing the issue of derivatives and section 1032, including (1) expanding the scope of section 1032 to cover all

[339] Advocates of the proposal would observe that so long as the forward price is higher than the market price on the contract date, there is at least a "profit" established in the forward contract (representing the time-value component of the contract) that should be taxable regardless of whether that profit is higher or lower than in it otherwise would be in the absence of the contract.

[340] See New York State Bar Association, "Report on Section 1032," 1999 TNT 199-22 (June 22, 1999).

derivatives in a corporation's stock, or (2) contracting the scope of section 1032 to cover only transactions in which a corporation issues or purchases its own stock for fair market value.[341]

Prior Action

An identical proposal was included in the President's fiscal year 2000, 2001, 2010 and 2011 budget proposals.

3. Require ordinary treatment for dealer activities with respect to section 1256 contracts

Present Law

In general

In general, gain or loss on the sale of stock in trade of a taxpayer or other property of a kind that properly would be included in inventory, or property that is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, is treated as ordinary income.[342] Consistent with this general rule, a taxpayer's status as a "dealer" in a particular type of property generally means that the taxpayer recognizes ordinary gain or loss when it engages in its day-to-day dealer activities, namely selling or exchanging the type of property for which it is a dealer.

A dealer in securities must compute its income pursuant to the mark-to-mark method of accounting.[343] Any security that is inventory in the hands of the dealer must be included in inventory at its fair market value; in the case of any security that is not inventory and that is held at the end of the taxable year, the dealer must recognize gain or loss as if the security had been sold for its fair market value. The resulting gain or loss generally is treated as ordinary gain or loss.[344]

Section 1256 contracts

Notwithstanding the general rule applicable to dealers, special rules apply to gains and losses of commodities dealers, commodities derivative dealers, dealers in securities, options dealers, and dealers in securities futures contracts or options with respect to "section 1256 contracts." Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss (the "60/40 rule").[345] Gains and losses upon the termination (or transfer) of a

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[341] New York State Bar Association, "Report on Section 1032."

[342] Sec. 1221(a)(1).

[343] Sec. 475(a).

[344] Sec. 475(d)(3).

[345] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[346] A taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.[347]

A "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.[348] The term "section 1256 contract" does not include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[349]

Dealers in section 1256 contracts

A "commodities dealer" is any person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.[350] Commodities dealers recognize capital gains and losses with respect to their section 1256 contracts unless they elect to have the rules of section 475 apply.[351]

A "commodities derivatives dealer" is a person that regularly offers to enter into, assume, offset, assign, or terminate positions in "commodities derivative financial instruments" with customers in the ordinary course of a trade or business.[352] Commodities derivative financial instruments held by a commodities derivatives dealer generally are not capital assets, and the sale or exchange of such instruments by a commodities derivatives dealer results in ordinary gain or loss.[353] However, the definition of "commodities derivative financial instruments" excludes section 1256 contracts.[354] As a result, the gains and losses of commodities derivatives dealers

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[346] Sec. 1256(c)(1).

[347] Sec. 1212(c).

[348] Sec. 1256(b)(1).

[349] Sec. 1256(b)(2).

[350] Sec. 1402(i)(2)(B).

[351] Sec. 1256(f)(3).

[352] Sec. 1221(b)(1)(A).

[353] Sec. 1221(a)(6).

[354] Section 1221(b)(1)(B) provides that the term "commodities derivative financial instrument" means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b))), the value or settlement price of which is calculated by or determined by reference to a "specified index." A specified index means any one or more or any combination of (1) a fixed rate, price, or amount, or (2) a variable rate, price, or amount, which is based on any current, objectively

with respect to section 1256 contracts typically are capital under the general rules of section 1256.

A "dealer in securities" is a taxpayer who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[355] The general rules applicable to securities dealers do not apply to section 1256 contracts held by security dealers. As a result, the gains and losses of dealers in securities with respect to section 1256 contracts typically are capital under the general rules of section 1256.

An "options dealer" is any person registered with a national securities exchange as a market maker or specialist in listed options, as well as any person whom the Secretary determines performs similar functions.[356] An option dealer's transactions with respect to both non-equity options and dealer equity options, both of which are section 1256 contracts, give rise to capital gain or loss under section 1256.[357]

A person is treated as a "dealer in securities futures contracts or options on such contracts" if the Secretary determines that such person performs, with respect to such contracts or options, as the case may be, functions similar to functions performed by an options dealer.[358] Dealer securities futures contracts are section 1256 contracts, and the transactions of a dealer in securities futures contracts with respect to such contracts give rise to capital gain or loss.[359]

Description of Proposal

The proposal requires commodities dealers, commodities derivatives dealers, dealers in securities, and options dealers to treat the income from their day-to-day dealer activities with

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determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances.

[355] Sec. 475(c)(1).

[356] Sec. 1256(g)(8).

[357] Sec. 1256(f)(3). This section, added as part of the Deficit Reduction Act of 1984 (H.R. 4170, Pub. L. No. 98-369), changed the rules for options market makers. Prior to the enactment of section 1256(f)(3), some options market makers took the position that options with respect to which they made a market were granted or acquired in the course of a trade or business. As a consequence, they maintained that transactions with respect to such options gave rise to ordinary income or loss. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 302.

[358] Sec. 1256(g)(9).

[359] Section 1256(g)(9)(A) provides that a "dealer securities futures contract" means, with respect to any dealer, any securities futures contract, and any option on such a contract, which (1) is entered into by such dealer (or, in the case of an option, is purchased or granted by such dealer) in the normal course of his activity of dealing in such contracts or options, as the case may be, and (2) is traded on a qualified board or exchange.

respect to section 1256 contracts as ordinary in character, not capital. The proposal does not affect the application of the mark-to-market rules with respect to such gains and losses.

Effective date.−The proposal is effective for taxable years beginning after the date of enactment.

Analysis

The proposal provides that a commodities dealer's, commodities derivative dealer's, securities dealer's, and an option dealer's gains and losses with respect to section 1256 contracts are treated as ordinary income. The proposal thus denies such dealers the benefits of the 60/40 rule, but allows net losses to be taken into account without regard to any capital loss limitations. The proposal does not otherwise affect the present-law requirement that such dealers report their section 1256 gains and losses under the mark-to-market method.

The 60/40 rule provides favorable treatment for certain dealers with respect to income that otherwise would not qualify for preferential capital gains treatment. This special treatment is not currently relevant in the case of corporate dealers because corporate capital gain is taxed at the same tax rates as ordinary income. For individuals, however, the 60/40 rule results in a maximum tax rate of 23 percent on their business income.[360] Proponents argue that eliminating the 60/40 rule for dealers is appropriate, because their business income should be taxed in the same manner as dealers of other types of property.[361]

On the other hand, Congress implicitly has acknowledged that the day-to-day activity of commodities dealers and options dealers with respect to section 1256 contracts is in fact "trading."[362] And section 1256(f)(3)(A), which provides that "trading" section 1256 contracts gives rise to capital gain or loss, is arguably nothing more than a codification of a basic tax principle. Thus, the Administration's proposal also could be viewed (at least with respect to commodities dealers and options dealers) as creating a special character rule for certain categories of traders.

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[360] This assumes a maximum long-term capital gain rate of 15% and a top individual income tax rate of 35% ((60 * (0.15)) + (40 * (0.35))).

[361] See, e.g., Erika W. Nijenhuis, "Taxation of Securities Futures Contracts," 897 *PLI/Tax* 477, 494-95 (2009) ("The 60/40 treatment provided by section 1256 is, however, a complete distortion of the Code's character rules, in two respects. First, it accords capital rather than ordinary treatment to taxpayers (dealers) who are acting in the normal course of their business activities. It does so, moreover, without imposing the normal limitations on the deductibility of capital losses, through a special rule that permits non-corporate taxpayers to carry back losses from section 1256 contracts to offset gains in prior years from such contracts. [Section 1212(c)] Second, it accords preferential long-term capital gain rates to taxpayers who have not made the long-term investment in capital assets that the rate differential is intended to encourage.").

[362] See Sec. 1402(i)(2)(B) (defining a "commodities dealer" as a person who is actively engaged in *trading* section 1256 contracts). Section 1256(f)(3), which by its terms is applicable to "trading" section 1256 contracts, was enacted for the purpose of codifying the character rules for commodities dealers and changing the character rules for options market makers, i.e., options dealers. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 312.

Furthermore, some will contend that the 60/40 rule, which was enacted in 1981 and expanded in 1984 and 2000, was intended to provide the benefit of a lower rate for these taxpayers who, by virtue of the enactment of the mark-to-market regime, were being required to pay tax with respect to gains prior to their realization. For purposes of determining a taxpayer's holding period, applying a mark-to-market method to capital assets creates uncertainty and complexity if a mark when the asset is still short term is followed by a second mark after the long-term holding period has been reached.[363] The 60/40 rule could be viewed as ameliorating these aspects of the mark-to-market regime and, therefore, its retention may be appropriate. Others would respond by noting that these concerns have become less significant since the 1993 enactment of section 475, which mandates mark-to-market treatment (and ordinary gain or loss) for dealers in securities.[364]

Prior Action

A similar proposal was included in the President's fiscal year 2001, 2010, and 2011 Budget Proposals.

4. Modify the definition of control for purposes of the section 249 deduction limitation

Present Law

In general, where a corporation repurchases its indebtedness for a price in excess of the adjusted issue price, the excess of the repurchase price over the adjusted issue price (the "repurchase premium") is deductible as interest.[365] However, in the case of indebtedness that is convertible into the stock of (1) the issuing corporation, (2) a corporation in control of the issuing corporation, or (3) a corporation controlled by the issuing corporation, section 249 provides that any repurchase premium is not deductible to the extent it exceeds "a normal call premium on bonds or other evidences of indebtedness which are not convertible."[366]

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[363] Even in the absence of the mark-to-market rules in section 1256, it is not clear that many traders would have a long-term holding period with respect to their section 1256 contracts. Traders make money by trading in and out of positions, not by buying and holding positions. Moreover, many section 1256 contracts, commodities futures in particular, have settlement dates that are less than one year from the date on which the parties initially enter into the contract.

[364] In 1997, section 475 was expanded to include an elective regime for commodities dealers (and traders in commodities and securities).

[365] See Treas. Reg. sec. 1.163-7(c).

[366] Regulations under section 249 provide that "[f]or a convertible obligation repurchased on or after March 2, 1998, a call premium specified in dollars under the terms of the obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including original issue discount) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased)." Treas. Reg. sec. 1.249-1(d)(2). Where a repurchase premium exceeds a normal call premium, the repurchase premium is still deductible to the extent that it is attributable to the cost of borrowing (e.g., a change in prevailing yields or the issuer's creditworthiness) and not attributable to the conversion feature. See Treas. Reg. sec. 1.249-1(e).

For purposes of section 249, the term "control" has the meaning assigned to such term by section 368(c). Section 368(c) defines "control" as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Thus, section 249 can apply to debt convertible into the stock of the issuer, the parent of the issuer, or a first-tier subsidiary of the issuer.

Description of Proposal

The proposal modifies the definition of "control" in section 249(b)(2) to incorporate indirect control relationships, of the nature described in section 1563(a)(1). Section 1563(a)(1) defines a parent-subsidiary controlled group as one or more chains of corporations connected through stock ownership with a common parent corporation if (1) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and (2) the common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

Effective date.−The proposal is effective on the date of enactment.

Analysis

Section 249 was added to the Code in 1969, and has not been altered substantially in 40 years. The reason for the original provision was explained by the staff of the Joint Committee on Taxation in 1969: "A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, the Congress believed that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner."[367] The extension of the basic rule of section 249 to the stock of a corporation in control of the issuer or a corporation controlled by the issuer can be viewed simply as an anti-avoidance measure.

The Administration now proposes to bolster the anti-avoidance rule by expanding the definition of "control." According to the Administration: "The definition of 'control' in section 249 is unnecessarily restrictive, and has resulted in situations in which the limitation in section 249 is too easily avoided. Indirect control relationships (e.g., a parent corporation and a second-tier subsidiary) present the same economic identity of interests as direct control relationships, and should be treated in a similar manner."

[367] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 131.

Similar changes have been proposed by others in the past. For instance, a 1987 report of the Tax Section of the New York State Bar Association noted: "Section 249 applies only to debt instruments convertible into stock of the issuer or a corporation controlled by or controlling the issuer, using the section 368(c) definition of control. This definition is overly narrow in some respects (e.g., a class of nonvoting preferred stock held by a third party would avoid a finding of control, and ownership attribution is not taken into account), and a statutory amendment to adopt a broader definition seems warranted."[368]

Prior Action

The same proposal was included in the President's 2010 and 2011 fiscal year budget proposals.

A substantially identical provision was passed in 2011 by the U.S. Senate as part of the "FAA Air Transportation Modernization and Safety Improvement Act" [369] but was not enacted.

[368] New York State Bar Association Tax Section, "Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations," in *Tax Notes* (December 30, 1986), n. 136 (citing 1986 proposed regulations under section 1272 which referenced the related party rules of section 108(e)(4)); see also Lee A. Sheppard, "A Real Mickey Mouse Deal (Or Can Disney Beat Section 249?)," 47 *Tax Notes* 1282 (June 11, 1990) (noting that "[o]thers have argued that the section 1504(a) standard should be used, so that section 249 would look through affiliated corporations"). Present law uses a more than 50 percent ownership test in determining control rather than an 80 percent ownership test in certain circumstances, see, e.g., section 108(e)(4) and Treas. Reg. sec. 1.1272-1(e).

[369] See sec. 812 of S. 223 (112th Cong., 1st Sess.), passed by the U.S. Senate on February 17, 2011.

B. Reinstate Superfund Environmental Income Tax

Present Law

The Superfund program addresses cleanup activity of hazardous substances at contaminated sites. Before January 1, 1996, four taxes were imposed to fund the Hazardous Substance Superfund Trust Fund ("Superfund"):

1. An excise tax on domestic crude oil and imported petroleum products;[370]

2. An excise tax on certain hazardous chemicals, imposed at rates that varied between $0.22 to $4.87 per ton;[371]

3. An excise tax on imported substances made with the chemicals subject to the tax in (2), above;[372] and

4. An income tax on corporations calculated using the alternative minimum tax rules.[373]

The taxes expired at the end of 1995. At the time the taxes expired, the Superfund Trust Fund had an unobligated balance of $4 billion.[374] By Fiscal Year 2004, the unobligated balance was zero.[375] As a result, the Superfund program has had to rely on general fund appropriations to fund the program.

The Environmental Protection Agency ("EPA") compiles the National Priorities List, which includes sites that the EPA has identified as having the greatest risk to human health and the environment. In many cases, potentially responsible parties ("PRPs") pay for the cleanups. Potentially responsible parties are responsible for more than 70 percent of the sites on the National Priorities List.[376] For approximately 30 percent of the National Priorities List sites, the EPA cannot locate the PRPs for these properties or the PRPs that are located do not have the financial resources to cover the cleanup. For this group of sites ("orphan sites"), the EPA uses funds from the Superfund to conduct cleanup activities.[377]

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[370] Sec. 4611(c)(2)(A).

[371] Sec. 4661.

[372] Sec. 4671.

[373] Sec. 59A.

[374] Congressional Research Service, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program* (February 4, 2008), p. 3.

[375] *Ibid.,* p. 4.

[376] *Ibid*., p. 1.

[377] *Ibid.*

Description of Proposal

The proposal reinstates the three Superfund excise taxes for periods after December 31, 2011. It would also reinstate the corporate environmental income tax for taxable years beginning after December 31, 2011. Both the excise and corporate income taxes would sunset after December 31, 2021.

Effective date.−The proposals are effective for periods after December 31, 2011 (for the Superfund excise taxes) and for taxable years beginning after December 31, 2011 (for the corporate environmental income tax).

Analysis

Some contend that the Superfund program has been underfinanced since the taxes that supported it expired in 1995 and that such underfunding has slowed the progress of cleaning up hundreds of orphan sites.[378] Thus proponents assert that the taxes dedicated to the trust fund should be reinstated to meet the continuing cleanup needs of orphan sites.

Opponents of the reinstatement of the taxes argue that the persons bearing the burden of the taxes are not the ones directly responsible for the contamination.[379] They argue that the cleanup of orphan sites is a broad societal problem that should be paid for by general revenues instead of levy on particular industries.[380] In contrast, some proponents argue that under a "polluter pays" principle, cleanup of the orphan sites should come from the industries that profited from the sale or use of the chemicals being cleaned up, even if those parties are not directly related to a particular release of a hazardous substance. Some have taken a more narrow view of "polluter pays" to include only those directly responsible for the contamination and assert that it is unfair to impose a tax on a person to compensate for another's transgression. Some would argue that even under the broader theory of "polluter pays," the corporate environmental income tax is inconsistent with this theory because the tax is imposed without regard to the particular product the corporation manufactures.

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[378] See Government Accountability Office, *Superfund: EPA's Estimated Costs to Remediate Existing Sites Exceed Current Funding Levels, and More Sites Are Expected to Be Added to the National Priorities List*, May 2010, pp. 11-19; Congressional Research Service, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program,* February 4, 2008, at CRS-8; John W. Broder, "Without Superfund Tax, Stimulus Aids Cleanups," *New York Times* (April 25, 2009), p. A16.

[379] American Chemistry Council, *ACC Responsible Parties Paying for Superfund Site CleanUp* (May 2010) ("It would be inappropriate and unfair to impose Superfund taxes on companies with no responsibility for site contamination.") available at http://www.americanchemistry.com/s_acc/sec_news_article.asp?CID=206&DID=11123

[380] American Petroleum Institute, Superfund Taxes (2011), available at http://api.org/policy/tax/apikeytaxissues/upload/Reinstate_Superfund_Taxes.pdf.

Prior Action

The same proposals were included in the President's fiscal year 2010 and 2011 budget proposals.[381]

[381] A similar proposal was included among the Fiscal Year 1999 budget proposals. See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal* (JCS-4-98), February 24, 1998 p. 225. The Clinton Administration requested reinstatement of the taxes annually in its budget submissions but Congress did not enact the proposal. Congressional Research Service, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program,* February 4, 2008, p. CRS-4.

C. Reform the U.S. International Tax System

1. Defer deduction of interest expense related to deferred income

Present Law

In general

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income whether derived in the United States or abroad. Income earned in the United States and foreign income earned directly or through a pass-through entity such as a partnership is generally taxed as the income is earned. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. federal income tax until such earnings are repatriated to the United States through a dividend distribution of those earnings to the U.S. person. Various tax regimes circumscribe the ability of U.S. persons to defer income by restricting or eliminating tax deferral with respect to certain categories of passive or highly mobile income. One of the main anti-deferral regimes is the controlled foreign corporation ("CFC") regime of sections 951 - 965 (referred to generally as "subpart F").

The subpart F regime taxes on a current basis a 10-percent U.S. shareholder's pro rata share of certain earnings of a foreign corporation (a CFC) that is owned more than 50 percent (by vote or value) by 10-percent U.S. shareholders. The income to which the subpart F rules apply includes foreign personal holding company income (among other items, certain dividends, interest, rents, and royalties) as well as foreign base company sales and services income, which include sales and services income from certain related party transactions. Subpart F also generally requires current taxation to the extent that a CFC increases its investment of earnings in U.S. property.[382]

The subpart F regime does not apply to a foreign corporation that is not a CFC, even if the foreign corporation has one or more 10-percent U.S. shareholders (commonly referred to as a "10/50 company"). Unless the foreign corporation is taxable under one of the other anti-deferral regimes,[383] the earnings of such a foreign corporation are generally taxable only upon distribution to the U.S. shareholder.

Deductibility of interest expense

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness.[384] An exception to this general rule provides that interest on indebtedness incurred or continued in connection with the purchase or carrying of

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[382] Sec. 956.

[383] One of the other anti-deferral regimes that may apply is the passive foreign investment company rules under sections 1291-1298.

[384] Sec. 163(a).

certain assets that generate tax-exempt interest or dividends is not deductible.[385] In contrast to this exception for interest attributable to tax-exempt income, no similar rules apply to limit the ability of a U.S. taxpayer with foreign operations to deduct its interest expense currently. As a result, a U.S. taxpayer may claim a current deduction for interest expense that it incurs to produce tax-deferred income through a foreign subsidiary.

Allocation and apportionment of interest expense

For the purpose of computing the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. As part of this determination, the taxpayer must allocate and apportion deductions between U.S.-source gross income and certain categories ("baskets") of foreign-source income (e.g., general limitation income and passive limitation income).

The current rules generally treat interest expense as being properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring a specific obligation on which interest is paid. For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets, rather than gross income.[386] An affiliated group in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[387] As with the rules for filing a consolidated return, the definition of affiliated group for interest allocation purposes generally also excludes foreign corporations.[388] Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply between the domestic and foreign members of a group.

In applying the asset method of interest apportionment, the taxpayer must apportion interest expense between U.S.-source income and the various baskets of foreign-source income

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[385] Sec. 265(a)(2), (a)(4).

[386] Sec. 864(e)(1), (e)(2).

[387] Sec. 864(e)(5). For consolidation purposes, the term affiliated group is one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations. Generally, an includible corporation is any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation. Sec. 1504.

[388] Secs. 864(e)(5), 1504(b)(3). An exception to this general rule excluding foreign corporations is that the affiliated group for interest allocation purposes includes a foreign corporation if more than 50 percent of its gross income for the taxable year is effectively connected with the conduct of a U.S. trade or business and at least 80 percent of the vote or value of all outstanding stock of the foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). Sec. 864(e)(5)(A).

based on the average total value of assets in each grouping for the year. For purposes of determining the value of its assets, the taxpayer may elect to value its assets based on (1) the tax book value method, (2) the alternative tax book value method, or (3) the fair market value method.[389] The taxpayer then determines the average value for the year based on the beginning and end of the year asset values unless such an approach results in a substantial distortion of asset values.[390]

Regardless of the method elected to value the assets, the taxpayer must determine whether the assets generate U.S.-source income, foreign-source income, or both. The Treasury regulations provide that the taxpayer must attribute assets to statutory groupings based on the source and type of income that the assets generate, have generated, or may be reasonably expected to generate.[391] The taxpayer categorizes its assets into one of three categories. The first category of assets is single category assets that generate income that is exclusively within a single statutory or residual group (e.g., general limitation foreign-source income, passive limitation foreign-source income, or U.S.-source income).[392] The second category is composed of multiple category assets that generate income in more than one limitation category (e.g., U.S. manufacturing assets that produce export property that generates partly general limitation foreign-source income and partly U.S.-source income under section 863(b)).[393] The third category is composed of assets without an identifiable yield. These assets either produce no directly identifiable income or contribute equally to the generation of all the income of the taxpayer (e.g., overhead related assets) and are excluded from asset-based apportionment.[394]

After the taxpayer categorizes the assets for purposes of determining whether they generate U.S.-source income or income in one of the baskets of foreign-source income, to apportion interest expense to a group the taxpayer multiplies the apportionable interest expense by a ratio in which the numerator is the average value of assets in the group and the denominator is total domestic and foreign assets of the taxpayer (hereinafter "the foreign asset ratio"). The resulting interest expense apportioned to each basket of foreign-source income then reduces gross foreign-source income in that basket for purposes of determining the foreign tax credit limitation in that basket.[395]

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[389] Temp. Treas. Reg. sec. 1.861-9T(g)(1)(ii).

[390] Temp. Treas. Reg. sec. 1.861-9T(g)(2)(i).

[391] Temp. Treas. Reg. sec. 1.861-9T(g)(3).

[392] Temp. Treas. Reg. sec. 1.861-9T(g)(3)(i).

[393] Temp. Treas. Reg. sec. 1.861-9T(g)(3)(ii).

[394] Temp. Treas. Reg. sec. 1.861-9T(g)(3)(iii).

[395] Sec. 904.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes "financial corporations."[396] A financial corporation includes any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591) the business of which is predominantly with persons other than related persons or their customers and which is required by State or Federal law to be operated separately from any other entity that is not a financial institution.[397] The category of financial corporations also includes bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business.[398]

Instead of treating a financial corporation as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Worldwide interest allocation

The American Jobs Creation Act of 2004 ("AJCA")[399] modified the interest expense allocation rules described above by providing a one-time election (the "worldwide affiliated group election") under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a "worldwide affiliated group" on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation).[400] If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio that the foreign assets of the worldwide affiliated group bears to

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[396] Temp. Treas. Reg. sec. 1.861-11T(d)(4).

[397] Sec. 864(e)(5)(C); Temp. Treas. Reg. sec. 1.861-11T(d)(4)(ii)(B), (C).

[398] Sec. 864(e)(5)(D); Temp. Treas. Reg. sec. 1.861-11T(d)(4)(ii)(A).

[399] Pub. L. No. 108-357, sec. 401.

[400] The "worldwide affiliated group" includes all corporations in an affiliated group as well as all CFCs that would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group, as modified to include insurance companies) and certain CFCs were attributable to a single corporation.

the total assets of the worldwide affiliated group,[401] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the principles of worldwide interest allocation were applied separately to the foreign members of the group.[402]

Financial institution group election

Similar to the general rules for allocating and apportioning interest expense that permit treating financial corporations as members of a separate affiliated group, taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide affiliated group approach. The rules also provide a one-time "financial institution group election" that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the bank group, and (2) all "financial corporations."[403]

Effective date of worldwide interest allocation

The common parent of the domestic affiliated group must make the worldwide affiliated group election or financial institution group election where applicable. It must be made for the first taxable year beginning after December 31, 2020, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group.[404] Once the election is made, it applies to the common parent and all other members of the worldwide affiliated group or to all members of the financial institution

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[401] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account. Sec. 864(f).

[402] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[403] A corporation is a "financial corporation" if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons. For these purposes, items of income or gain from a transaction or a series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

[404] As originally enacted under AJCA, the worldwide interest allocation rules were effective for taxable years beginning after December 31, 2008. However, the Housing and Economic Recovery Act of 2008 delayed the implementation of the worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. Pub. L. No. 110-289, sec. 3093. The implementation of the worldwide interest allocation rules was further delayed by seven years, until taxable years beginning after December 31, 2017, by the Worker, Homeownership, and Business Assistance Act of 2009. Pub. L. No. 111-92, sec. 15. It has since been delayed until taxable years beginning after December 31, 2020, by the Hiring Incentives to Restore Employment Act of 2010. Pub. L. No. 111-147, sec. 551.

group, as applicable, for the taxable year for which the election is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

Description of Proposal

The proposal defers the deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax. For purposes of the proposal, foreign-source income earned by a taxpayer through a branch is considered currently subject to U.S. tax; thus, the proposal does not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign-source income (for example, royalty income) is similarly treated.

For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to foreign-source income is generally determined under current Treasury regulations. The Treasury Department, however, will revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.

Under the proposal, deferred interest expense is deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during that subsequent tax year. Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expense in certain cases.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

Overview

The Administration states that the ability to deduct interest expense attributable to foreign investments while deferring U.S. tax on the income from the investments may cause U.S. businesses to shift their investments and jobs overseas, harming the domestic economy.[405] To address this concern, the proposal eliminates a U.S. person's ability to deduct interest expense currently to the extent that it is allocated and apportioned to foreign-source income on which U.S. tax is deferred. The deduction for such interest expense is deferred until the previously deferred income is subject to U.S. tax. By taking this approach, the proposal seeks to match more closely the timing of interest expense deductions with income inclusion.

The analysis that follows discusses: (1) whether the matching of the timing of interest expense recognition to the taxation of foreign source income is appropriate; (2) the effect of deferral on investment decisions and the impact the proposal may have on U.S. multinational

[405] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, p. 40.

corporations ("MNCs"); (3) the effect of deferral on residence choice and the impact of the proposal; (4) the manner in which deferred interest expense will be determined under the proposal, and (5) certain technical considerations.

Matching

The proposal seeks to more closely match the timing of interest expense deductions apportioned to foreign-source income with the recognition of such income. In this respect, the proposal is consistent with other Code provisions that require capitalization of costs, with recovery over a period of time to clearly reflect taxable income for a particular taxable year.[406] The Supreme Court recognized this matching concept in *INDOPCO, Inc. v. Commissioner*, noting that "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."[407] Additionally, various provisions of the Code require matching of items of a similar character through the delay of otherwise deductible amounts to future years in which income is realized.[408]

By deferring the deduction for interest expense until previously deferred foreign-source income is currently subject to U.S. taxation, such interest expense deductions arguably would be more closely matched with the revenues of the taxable period to which they are attributable, resulting in a more accurate calculation of taxable income for the taxable period. As discussed above in the present law section, the current rules for interest expense apportionment are based on the concept that money is fungible and require the use of an asset method for the allocation and apportionment of interest expense. Therefore, some may contend that any "matching" would lack the direct correlation of the related income and expense as is the case with other Code provisions that impose a matching requirement.

If the asset method of interest expense apportionment is used as a proxy for a true matching of interest expense to deferred foreign income, one commentator has suggested that the results may be harsh and excessive compared with a true application of the matching principle since the approach would not differentiate between taxpayers with deferred foreign income that are benefiting from deferral (because the foreign tax rate on the deferred foreign income is lower the U.S. tax rate applicable to those earnings) and those taxpayers that are not benefiting from such deferral (because there is little or no differential between the U.S. and foreign tax rate).

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[406] See, e.g., sec. 263(a) and sec. 263A. See also, Treas. Reg. sec. 1.461-5, which provide rules for the recurring item exception to the economic performance requirement of section 461(h), includes a provision requiring taxpayers to determine whether the accrual of a liability for the taxable year results in a better matching of the liability with the income to which it relates than if the liability were incurred in the taxable year economic performance actually occurs.

[407] *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

[408] Sections 163(d), 465, 469, and 1092 similarly require delay of otherwise deductible amounts to future years in which income is realized. Deborah A. Geier, "The Myth of the Matching Principle as a Tax Value," 15 *American Journal of Tax Policy* 17 (Spring 1998), p. 19.

To achieve a better matching of interest expense and deferred foreign income, the commentator suggests limiting the deferred interest expense deduction to the amount of interest expense attributable to deferred foreign income in a jurisdiction multiplied by a percentage equal to the excess of the U.S. statutory tax rate over the applicable foreign tax rate divided by the U.S. statutory tax rate.[409] For example, if the deferred foreign income were in a CFC in Ireland where the statutory rate is 12.5 percent, the percentage of interest expense attributable to deferred foreign income at the Irish CFC that would be deferred would only be 64 percent ((35 percent - 12.5 percent)/35 percent). This modified approach, however, poses significant administrative difficulties because it requires a determination of applicable foreign tax rates.

Despite the administrative difficulties of the commentator's modified approach, the modified approach has value at the conceptual level. Specifically, the commentator's modified approach highlights the point that policymakers should, as an initial step, consider whether a modification to present law to more closely matching the timing of interest expense deductions with foreign income inclusions is the appropriate policy. If it is determined that a better matching is the appropriate policy, then consideration should then be given as to what is the best method to accomplish this matching.

Due to the lack of matching relating to the deduction of interest expense attributable to foreign income under present law, a U.S. MNC making an overseas investment may be in a better after-tax position as compared with a U.S. MNC making a similar U.S. domestic investment because the deduction yields low (and, in some cases, negative) effective tax rates on foreign income on which U.S. tax is deferred. This effect of failing to allocate expenses against exempt foreign-source income has been described as facilitating negative effective tax rates for overseas investments, by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deductions in the United States.[410] An analogous situation arises in connection with the allocation of expenses between exempt and nonexempt income in a territorial tax system. As a consequence, recent proposals for the adoption of an exemption system in the United States have stressed the increased importance of expense allocation rules and the need to ensure that expenses attributable to the production of exempt foreign income do not inappropriately reduce U.S. tax on domestic source or other nonexempt income.[411]

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[409] Martin A. Sullivan, "Economic Analysis: Obama Chooses a Clumsy Way to Limit Deferral," 123 *Tax Notes* 1163 (June 8, 2009). This approach would synthetically create a result similar to that which could be achieved with a multilateral approach to interest expense allocation where the amount treated as attributable to deferred foreign income of a foreign subsidiary would be deducted on the subsidiary's tax return for foreign tax purposes. See Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," *IBFD, Bulletin for International Taxation* (November 2008), p. 486.

[410] Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices and Implications*, edited by John W. Diamond, George R. Zodrow (2008), MIT Press, Cambridge (hereafter, Grubert and Altshuler, Corporate Taxes in the World Economy), p. 328. For a numerical illustration, see Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," *IBFD, Bulletin for International Taxation* (November 2008), p. 486.

[411] See, e.g., President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro Growth: Proposal to Fix America's Tax System* Washington, D.C., 2005, (hereafter, President's Advisory Panel on Federal Tax Reform, *Proposal to Fix America's Tax System)* Joint Committee on Taxation, *Options to Improve Tax Compliance*

It is noteworthy that other OECD member countries that provide for either the deferral or exemption of active foreign subsidiary income do not generally defer or disallow expenses, such as interest, attributable to the deferred or exempt foreign income.[412] As a result, if the proposal is enacted, some may argue the United States would move even further from international norms. While other jurisdictions may not have regimes in place to specifically defer or disallow interest expense attributable to deferred or exempt foreign income, some jurisdictions that have adopted territorial regimes have recently made significant changes to their thin capitalization rules in order to limit base erosion. An example of such a regime is the United Kingdom's worldwide debt cap limitation recently enacted in conjunction with a dividend exemption regime. This worldwide dept cap limitation restricts the deductibility of interest and other finance expense on intra-group debt of U.K. companies in cases in which the U.K. interest expense is excessive by reference to such expense in the worldwide group.[413] Similarly, Germany has recently enacted new thin capitalization rules that generally apply to interest expense on all debt of German corporations.[414] In addition, rather than formally implementing expense disallowance rules, some jurisdictions with territorial regimes (e.g., France, Germany, and Japan) instead, provide less than a full dividend exemption (95 percent rather than 100 percent) as a proxy for taking into account expenses associated with the earning of exempt foreign income.[415]

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and Reform Tax Expenditures, JCS-02-05 (January 27, 2005) (hereafter, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures).* But see U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (December 20, 2007) (hereafter, U.S. Department of the Treasury *Approaches to Improve Competitiveness)* (proposing a dividend exemption system without allocation of interest expense).

[412] Switzerland has rules requiring a formulary allocation of interest expense to exempt foreign income which has an effect similar to a disallowance of interest expense deductions; however, these rules generally only apply to the extent such interest (allocated under an asset ratio method) is attributable to a foreign participation in a year in which the foreign participation distributes an exempt dividend to Switzerland. Circular Letter no. 27 of the FTA of December 17, 2009, Participation Exemptions, chapter 2.6.2.

[413] Under these rules, a Gateway Test is applied to determine if net debt of the U.K. taxpayer is greater than 75 percent of the gross debt of the worldwide group. If the net debt exceeds this threshold, the U.K. company must apply more detailed rules to determine the portion of related party interest expense that is disallowed. These rules, however, do not apply to certain qualifying financial services groups. Susan Bell, "Section 11 and Schedule 5: worldwide debt cap," reprinted from *British Tax Review*, Issue 1, 2011, http://www.freshfields.com/publications/pdfs/2011/mar11/BTR%2001%202011%20SB%20Offprint.pdf; HR Revenue and Customs, Relief for Interest: Amendments to the "Worldwide Debt Cap Legislation," http://www.hmrc.gov.uk/budget2010/bn07.pdf.

[414] Subject to certain exceptions, a German taxpayer may only deduct net interest expense to the extent of 30 percent of its EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization). However, where the German taxpayer can demonstrate that its German equity ratio (equity divided by gross assets) is not more than two percent less than that of its worldwide group, the 30-percent EBITDA limitation generally will not apply. Wolfgang Kessler and Rolf Eicke, "Germany's Growth Acceleration Act - Taming the Sunshine Tax Legislation," *Tax Notes International* (April 12, 2010), p. 127; Stefan Grube and Thomas Wagner, "News Analysis: Germany's Proposed Interest Deduction Limitation Rules," *Tax Notes International* (November 30, 2009), p. 640.

[415] PricewaterhouseCoopers, Worldwide Tax Summaries (France), at http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf/id/MTHN-6QDJGN?OpenDocument; PricewaterhouseCoopers, Worldwide Tax Summaries (Germany), at http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf/id/MTHN-6QDHPP?OpenDocument;

Although the proposal may make investment in foreign jurisdictions less attractive, to the extent a U.S. MNC undertakes that investment, the U.S. MNC will face the same general barrier to repatriating earnings that it faces under present law — it will be subject to residual U.S. tax on those earnings, subject to possible reduction by a foreign tax credit. Nonetheless, a U.S. MNC may be encouraged to repatriate earnings under the proposal if doing so would allow the taxpayer to take foreign-related interest deductions that previously had been deferred. If, however, the proposal is analyzed in combination with the Administration's proposal to determine the amount of the foreign tax credit on a blended basis (described below), in some circumstances taxpayers may face a greater tax burden on repatriation than they do under present law.[416]

Effect of deferral on investment decisions`

Comparison of U.S. MNCs to domestic taxpayers

When evaluating the aspects of present law that permit a U.S. MNC to defer active foreign earnings of its foreign subsidiaries from U.S. taxation, some may believe it is most appropriate to consider the ability of a U.S. MNC to defer the U.S. taxation of income earned in connection with a foreign investment opportunity as compared to that of another U.S. taxpayer that invests only in the United States.[417]

The principal advantage of deferral, when comparing one U.S. taxpayer's foreign investment opportunity to another U.S. taxpayer's domestic investment opportunity, is the ability to retain and invest low-taxed earnings in a foreign subsidiary on a pre-U.S. tax basis. Suppose that a U.S. taxpayer in the 35-percent tax bracket is considering whether to make an investment in an active enterprise in the United States or in an equivalent investment opportunity in a country in which the income tax rate is zero. Assume the U.S. taxpayer chooses to make the investment in the foreign country through a CFC that earns $100 of active income today, and the U.S. taxpayer defers tax on that income for five years by re-investing the income in the CFC. Assume further that the CFC can invest the money and earn a 10-percent return per year, and the

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PricewaterhouseCoopers, Worldwide tax summaries (Japan), at http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf/id/MTHN-6QDGYU?OpenDocument.

[416] See George K. Yin, "Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers," *Tax Notes*, 118, (January 7, 2008), p. 178. See also Martin A. Sullivan, "Economic Analysis: FTC Proposal Puts Brakes on Earnings Coming Home," *Tax Notes International*, 54 (June 1, 2009), p. 717.

[417] Analyzing the proposal in this manner may be construed as taking an approach that focuses on promoting economic efficiency or economic welfare through a policy of Capital Export Neutrality ("CEN"). In general, U.S. tax policies associated with CEN focus on minimizing distortions for U.S. taxpayers in determining the location of investment. The goal of CEN is achieved if pre-tax rates of return on investment are the same across jurisdictions (although after-tax returns for investors in different jurisdictions may vary). This policy goal of CEN would generally be achieved if each country adopts a tax system in which its residents are taxed on a worldwide basis without deferral but with an unlimited foreign tax credit. To the extent the expense deferral proposal has the impact of a partial repeal of deferral for some taxpayers, it may be considered as moving in the direction of promoting CEN. Peggy Brewer Richman (Musgrave), "The Taxation of Foreign Investment Income: An Economic Analysis," *The Johns Hopkins Press* (1963).

income earned is not subject to foreign tax or subpart F. The taxpayer would then have $161.05 and pay tax of $56.37 on repatriation, for an after-tax income of $104.68.

If, instead, the U.S. taxpayer pursues the equivalent investment opportunity in the United States, such an investment will not be eligible for deferral. As a result, the taxpayer receives $100 in income today, pays tax of $35, and has only $65 to invest. The taxpayer invests that amount at an after-tax rate of 6.5 percent (this is a 10-percent pre-tax rate less 35 percent tax on the earnings each year). At the end of five years, this taxpayer will have after-tax income of only $89.06, as compared to the foreign investment option which would generate after-tax income of $104.68. The result is that the foreign investment option to defer tax on the income for five years leaves the taxpayer with $15.62 more in economic wealth than the domestic investment option that would require the taxpayer to pay tax on the income immediately, even though the pre-tax rate of return (10 percent) and the U.S. tax rate (35 percent) are the same for both investments. As a result, the foreign investment would be the preferred choice (all else being equal).

The disparity in after-tax effects described above means that there may be foreign investments that earn less on a pre-tax basis than an investment in the United States, but may, nonetheless, result in a greater return on an after-tax basis. Thus, deferral may distort the investment choice when it creates an incentive to choose an overseas investment that yields a lower pre-tax rate of return over a domestic investment that yields a higher pre-tax rate of return. When the lower earning investment is chosen, society as a whole loses the opportunity for greater total income. Economists label such an outcome a social welfare loss from an inefficient allocation of investment.

Generally, the greater the foreign effective marginal tax rate, the closer the rate of return on the investment must be to the rate on the U.S. investment to yield a superior after-tax return. As the foreign tax rate approaches the U.S. tax rate, the distortion approaches zero. By contrast, the longer the residual U.S. income tax is deferred, the less the foreign investment has to earn relative to a U.S. investment and the greater the distortion.[418]

While there are many nontax motivations for foreign direct investment, if a taxpayer has made an investment abroad and that investment is in a country with a tax rate lower than that of the United States, this investment choice may create a second-order distortion in that it can be to the taxpayer's advantage to attribute as much income as possible to that investment in order to

[418] An alternative way to think about the trade-off between the deferral period, the foreign tax rate, and the break-even rate of return on a deferred offshore investment is as follows. The longer the period of deferral, the lower the effective residual U.S. tax rate. In fact, permanent deferral would create an effective rate residual tax rate equal to zero. Thus, as deferral increases, the effective total tax rate (U.S. residual tax plus foreign host country tax) that the U.S. taxpayer faces approaches the foreign host country tax rate. Consequently, as deferral increases, the break-even return on a deferred offshore investment declines and approaches the rate of return on the foreign investment net of the foreign host country tax.

exploit the possible benefit of deferral. This incentive may put pressure on the determination and administration of transfer pricing rules.[419]

The proposal would eliminate present law's effective tax rate disparity between U.S. and foreign investment to the extent the disparity is attributable to the allowance of a deduction for interest expense attributable to deferred foreign income. To the extent that differentials between effective tax rates on foreign investment and on U.S. investment are reduced, the distortion of the choice of where to invest, the United States or abroad, and the related second-order distortions may be reduced.

If the proposal has the effect of reducing incentives to invest abroad rather than in the United States, it is possible that investment in the United States by U.S. taxpayers may increase. However, empirical research has not produced definitive conclusions about the effect of foreign direct investment on U.S. labor productivity, wages, and aggregate national income.[420]

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[419] Commentators suggest that the issue of addressing improper transfer pricing practices can be similarly problematic in jurisdictions with territorial regimes. J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (December 7, 2009), p. 1084. Others suggest that this pressure on transfer pricing can be relieved by ensuring the average corporate tax rate in the United States is more in line with the rest of the world. Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, "The U.S. International Tax System at a Crossroads," 127 *Tax Notes* 45 (April 5, 2010), p. 63.

[420] Robert E. Lipsey, Outward Direct Investment and the U.S. Economy, in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, Chicago: University of Chicago Press (1995). In later research, Lipsey reaches similar conclusions. Robert E. Lipsey, Home and Host Country Effects of FDI, in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization,* Chicago: University of Chicago Press (2004), pp. 333-379. The evidence does, however, suggest that overseas production displaces certain types of domestic production, as the parent firm shifts to more capital intensive and skill intensive domestic production. Lipsey, "Home and Host Country Effects of FDI."

There is no definitive conclusion about the effect of outbound investment on U.S. employment. The same survey concludes, "[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment . . . ." Lipsey, "Outward Direct Investment and the U.S. Economy," p. 31. One study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, "Are U.S. Multinationals Exporting U.S. Jobs?" in David Greenway and Douglas Nelson, (eds.), *Globalization and Labour Markets*, Elgar (2001). However, most of the evidence on this subject examines individual industries rather than aggregate economic effects.

The results of a recent study suggest that foreign direct investment may be complementary to and not a substitute for domestic investment. This study was based on firm-level data on domestic and foreign operations of U.S. manufacturers for the period of 1982 - 2004 and found that (1) a 10-percent greater foreign investment is associated with 2.5-percent greater domestic investment; (2) a 10-percent greater foreign employee compensation is associated with 3.7-percent greater domestic employee compensation; and (3) a 10-percent greater sales by foreign affiliates is associated with 6.5-percent greater exports by U.S. parents to their foreign affiliates. Mihir Desai, C. Fritz Foley and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy* (February 2009).

Although the proposal may reduce the investment location distortions, present law does not create a distortion for investments that are not profitable or that face foreign tax rates equal to the U.S. rate. Moreover, the distortion is lessened when pre-tax returns abroad are higher than U.S. pre-tax returns.

Others may challenge the general premise that pre-tax returns on overseas investment options will generally be lower than comparable domestic investment options. Arguably, for U.S. MNCs in relatively mature U.S. markets, there may be more opportunities for higher pre-tax rates of return abroad than in the United States where there may be less competition. Furthermore, for those U.S. MNCs, the only significant investment opportunities may be in foreign markets because comparable domestic markets have been saturated.

In general, the tax analysis described above may be only part of a broader evaluation that U.S. firms engage in when considering whether to invest in the United States or abroad. There are many reasons that may motivate a U.S. MNC to make an outbound foreign direct investment. Building a plant abroad may be the most cost efficient way for a U.S. MNC to gain access to a foreign market. Trade barriers or transportation costs could make it prohibitively costly to serve the foreign market by direct export from a U.S. location. Foreign direct investment may put the U.S. MNC physically closer to its customers, allowing better customer service and providing a better understanding of the foreign market, which can serve as the basis for improved future marketing of goods and services. A U.S. MNC may make an outbound foreign direct investment to lower operating costs by exploiting less expensive, or more skilled, foreign labor, less expensive access to important raw materials or components from suppliers, or to permit operation in a less burdensome regulatory environment. In addition, foreign direct investment may provide access to foreign-developed technology.

The relative importance of tax and nontax considerations may vary among different kinds of investments. Mobile investments requiring relatively low expenditures on tangible capital or labor, including investments in intellectual property, may be more sensitive to tax rates than investments in plants and other operations that are closely tied to the economic environments in the localities in which those investments are made.[421]

Comparison of U.S. MNC taxpayers to foreign MNCs

Others may believe that the proposal should instead be evaluated by comparing the tax treatment of a U.S. MNC considering a foreign investment to that of a foreign MNC evaluating a similar investment in a third country (not the country in which the foreign investor is tax resident).[422] In making this comparison to foreign MNCs resident in countries that provide for

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[421] For a more detailed discussion, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 1-10.

[422] Evaluating the proposal from this perspective may be construed as taking an approach that focuses on promoting economic efficiency or economic welfare through the lens of Capital Import Neutrality ("CIN") or Capital Ownership Neutrality ("CON"). The CIN principle focuses on minimizing distortions in the level of savings across jurisdictions; the goal is achieved if the after-tax rate of return on a given investment in a specific location is the same for all investors (although pre-tax rates of return on investments may differ across jurisdictions). Thomas Horst, "A Note on Optimal Taxation of International Investment Income," *Quarterly Journal of Economics,* vol. 41,

the exemption of active foreign subsidiary income, it is argued that the ability of a U.S. MNC to defer U.S. taxation of active overseas earnings should not be viewed as a competitive advantage. Rather, proponents of comparing U.S. and foreign MNCs argue the ability of a U.S. MNC to defer U.S. taxation of active foreign earnings is a critical factor in allowing the U.S. MNC to compete with a foreign competitor based in a jurisdiction that has a territorial or exemption regime that exempts active foreign subsidiary income from taxation.

Advocates of this perspective sometimes note that, of the 34 countries that make up the Organisation for Economic Cooperation and Development (the "OECD"), 26 now have territorial tax systems, including, beginning in 2009, Japan and the United Kingdom.[423] Thus, only seven OECD countries other than the United States, have worldwide tax systems (Chile, Greece, Ireland, Israel, Korea, Mexico, and Poland). These seven jurisdictions have significantly less outbound foreign direct investment and lower statutory corporate tax rates (an unweighted average of 21.7 percent in 2010) than the United States.[424] They may also argue the United States is already an outlier with its present regime of worldwide taxation with deferral for U.S. taxpayers. They maintain that residual U.S. taxation on foreign earnings puts a U.S. MNC in a worse position relative to a foreign competitor based in a country with an exemption regime.

(2003). The CON principle focuses on minimizing distortions in the ownership of assets with this goal being achieved if productive assets (wherever located) are owned by persons (wherever resident) that have the ability to generate the highest pre-tax returns. Although the goals of both CIN and CON can generally be achieved if each country adopts a territorial tax system (i.e., exempting income earned abroad), the goals of CON can also generally be achieved if every country adopts a full-inclusion worldwide tax system and effectively harmonized rates. With the adoption of territorial systems by many of our trading partners, proponents of CON argue that the only practical way that the United States can achieve CON is to move to a territorial regime as well. Mihir A. Desai and James R. Hines, Jr., "Evaluating International Tax Reform," 56 *National Tax Journal* 487 (September 2003). See also Mihir Desai and James R. Hines, Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," 57 *National Tax Journal* 937 (December 2004).

Others contend that the arguments supporting the use of neutrality models such as CEN, CIN, and CON as benchmarks to guide the tax reform process are not satisfactory as they must take place within very simple models. They advocate an alternative approach that considers how the existing tax system creates behavioral distortions among taxpayers (and, to a lesser extent, governments) and whether a given proposal is likely to have success mitigating such distortions. These behavioral distortions include (1) the location of tangible capital, (2) the location of intangible capital, (3) the repatriation decision, (4) financing decisions, (5) income shifting, (6) incentives to lower foreign tax burdens, (7) export decisions, and (8) host government decisions regarding the taxation of U.S. companies. Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," paper prepared for presentation at the James A. Baker III Institute for Public Policy conference, "Is it Time for Fundamental Tax Reform?: The Known, Unknown, and Unknowable," April 27-28, 2006 (December 12, 2006).

[423] For the tax treatment of foreign dividend income in each jurisdiction, see PricewaterhouseCoopers, *Worldwide Tax Summaries: Corporate Taxes 2010/2011*, http://www.pwc.com/gx/en/worldwide-tax-summaries/index.jhtml; see also Ernst & Young, *The 2010 Worldwide Corporate Tax Guide*, http://www2.eycom.ch/publications/items/tax/2010_worldwide_corporate_tax_guide/2010_EY_worldwide_corporate_tax_guide.pdf.

[424] The statutory corporate income tax rate in each of these jurisdictions is as follows for 2010: (1) Chile at 17 percent; (2) Greece at 24 percent; (3) Ireland at 12.5 percent; (4) Israel at 25 percent; (5) Korea at 24.2 percent; (6) Mexico at 30 percent; and (7) Poland at 19 percent. "Taxation of Corporate and Capital Income Table II.1," http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_37427,00.html#cci.

Consequently, any proposal that increases U.S. residual taxation only enhances this disadvantage.

Arguably, the proposal may have an impact similar to a partial repeal of deferral for U.S. corporate taxpayers to the extent such taxpayers have significant U.S. debt. This impact may cause concerns about the competitiveness of U.S. MNCs. Although these competitiveness arguments have been espoused in different ways, the fundamental aspects of the arguments have a common thread focusing on how a proposal to repeal deferral will increase the cost of capital to U.S. MNCs. Consider a U.S. MNC that is subject to tax in the United States at a 35-percent rate on the worldwide income it earns directly, as well as on its active foreign income when repatriated, and a foreign MNC that is resident in a jurisdiction that exempts active foreign income from taxation upon its repatriation. Assume the corporate income tax rate everywhere outside the United States is 25 percent. The income of the foreign MNC from operations in the United States is taxed at the prevailing U.S. corporate income tax rate, 35 percent, as is the income earned by the U.S. MNC. On the other hand, the income earned by the foreign MNC from operations outside the United States is taxed at 25 percent. Under present law, the U.S. MNC arguably may achieve a similar result through deferral.

Absent deferral, however, the income earned by the U.S. MNC from operations in the United States would continue to be taxed at the prevailing U.S. corporate tax rate, generally 35 percent, and the income earned by the U.S. MNC from operations outside the United States would also be taxed at 35 percent. All else being equal, the foreign MNC may have a higher after-tax return than the U.S. corporation. Shareholders, regardless of residence, may view the shares of the foreign MNC as more valuable, because the foreign MNC could pay higher dividends from its after-tax income. As a result, the foreign MNC may have a greater ability to raise capital and that could affect whether the U.S. corporate taxpayer or its foreign competitor wins a competitive bid. If capital investment is shifted from U.S. MNCs to foreign MNCs (e.g., U.S. persons buying shares in foreign-headquartered firms as opposed to U.S.-headquartered firms), some argue this could lead to (1) U.S. MNCs having greater difficulty growing; (2) foreign competitors of U.S. MNCs gaining market share and other business advantages by virtue of being the first to market in certain sectors; and (3) U.S. MNCs becoming more attractive acquisition targets for foreign acquirers to the extent that U.S. MNCs can only capitalize on their global synergies at higher costs due to the U.S. tax on foreign investment.[425]

If the proposal were enacted, in the short run a U.S. MNC would, in general, have two options: (1) continue to defer tax on its overseas active earnings and forgo the portion of the interest expense deduction attributable to the deferred foreign income resulting in an increase in its U.S. tax liability (35 percent multiplied by the forgone current deduction); or (2) repatriate the overseas active earnings and subject the earnings to full U.S. taxation (with offset for a foreign tax credit, as limited) so that it can continue to deduct fully its U.S. interest expense. Perhaps for

[425] Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, "The U.S. International Tax System at a Crossroads," 127 *Tax Notes* 45 (April 5, 2010), pp. 61 and 63.

this reason, some suggest that the proposal should only be considered in the context of broader corporate international tax reform.[426]

Proponents of this proposal may, however, challenge this general assertion that there is a competitiveness problem stemming from the current U.S. international tax regime that would be further exacerbated by this proposal. They may point to the successes of U.S. MNCs in foreign markets and that the lack of empirical data supporting such competitiveness concerns makes these arguments questionable. Moreover, if there are issues of competitiveness in certain U.S. industries, proponents of the proposal may challenge the assertion that these issues are primarily attributable to U.S. international tax policy rather than labor cost differentials, product quality differences, regulatory differences, and other nontax factors.[427]

Effect of deferral on residence choice

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any state. All other corporations (i.e., those incorporated under the laws of foreign countries) are generally treated as foreign. Only U.S. corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has sufficient nexus in the United States. As a result, present law contains powerful tax incentives for a new firm to opt out of U.S. residence for its top-tier entity.

These tax incentives may lead to an economic distortion that consists of two components. First, an enterprise that in the absence of the prevailing tax policy would have naturally chosen to incorporate in the United States chooses to incorporate elsewhere. This decision creates a "second order" distortion in that, by incorporating outside the United States, the enterprise removes its future earnings from the U.S. tax base. The impact of this economic distortion on the U.S. tax base may result in higher taxes elsewhere in the economy. Increasing other taxes will increase the economic distortions inherent in those other taxes.

To the extent the proposal increases the effective U.S. tax rate on foreign investment by U.S. firms, firms with U.S. and overseas operations will have an added incentive to conduct their overseas operations not through foreign subsidiaries of U.S. domestic corporations but instead through firms that are owned by foreign persons.[428] If this incentive were strong, it would be possible that over time, the only significant business operations carried out through U.S.-headed

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[426] See generally Amy S. Elliott, "International Tax Reform Won't Proceed Without Larger Tax Reform, Finance Aide Says," 2010 *Tax Notes Today* 44-5 (March 8, 2010). See also Chuck O'Toole, "Levin Says Deferral Can Wait but Targets Tax Havens, Bush Tax Cuts," 2010 *Tax Notes Today* 51-3 (March 17, 2010).

[427] See, e.g., J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (December 7, 2009), p. 1086.

[428] This analysis assumes that firms will have the ability to conduct foreign operations through firms organized in jurisdictions that do not impose tax on worldwide income. Many countries, including most of the major trading partners of the United States, have adopted territorial taxing regimes.

firms would be U.S. business operations dealing directly with unrelated U.S. customers. Assuming, however, that anti-inversion rules are effective, existing U.S. firms may be limited in their ability to migrate their existing operations into foreign-headed firms, as the U.S. anti-inversion rules would either prevent the successful migration of these operations or require these U.S. firms to incur significant tax costs to accomplish the migration.[429] Consequently, if the proposal increases the incentive to conduct foreign operations through foreign-headed groups, a possible scenario would be that existing U.S.-headed businesses would remain U.S.-owned (or be acquired by foreign firms) and new foreign business operations would be organized with foreign corporations as the parent entities. Under this scenario, the proposal would impose additional U.S. tax on existing capital investment but, over time, would fail to capture returns from new capital investment in foreign business operations.

Nonetheless, as discussed above in the context of competitiveness, it may be argued that the existing U.S. worldwide tax regime has long created a disincentive to conduct foreign operations through U.S.-headed firms. In spite of this disincentive — which predated and served as the impetus for the enactment in AJCA of the anti-inversion rules — U.S. MNCs have accounted and still account for a significant portion of cross-border economic activity.[430] A possible explanation is that nontax reasons for organizing global operations under a U.S. parent corporation dominate the tax consequences of such a structure. Regardless, if, in response to the proposal, firms conduct new foreign operations through entities organized in foreign jurisdictions, this may not be so much an argument against the proposal as it may be a suggestion of the malleability of corporate residence based on the U.S. place-of-incorporation rule.[431]

To the extent the proposal has the effect of encouraging new foreign business operations to be conducted through foreign-headed rather than U.S.-headed firms, this effect could be exacerbated if the proposal were enacted in combination with other Administration proposals such as the proposals to determine the foreign tax credit on a blended basis and to tax currently excess returns associated with transfers of intangibles offshore.

Determination of interest expense to be deferred

Analysis of this proposal requires consideration of the methodology to determine the portion of interest attributable to foreign income not currently subject to U.S. tax as well as the pool of earnings that will be considered as not currently subject to U.S. tax. The proposal

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[429] Sec. 7874.

[430] In 2007, nonbank U.S. multinational firms were associated with 49 percent of all U.S. exports of goods and 37 percent of all U.S. imports of goods. Kevin B. Barefoot, Raymond J. Mataloni, Jr., "U.S. Multinational Companies: Operations in the United States and Abroad in 2007," *Survey of Current Business* (August 2009), 89:8, Table 3, page 68. Notwithstanding the continued success of U.S. multinational corporations, a recent study found that the number of U.S. headquartered Fortune Global 500 companies decreased from 36 percent in 2000 to 28 percent in 2009. Tom Neubig, Tiffany Young and Barbara M. Angus, "The changing landscape of headquarters locations and headquarter taxation of Fortune Global 500 companies," http://www.ey.com/Publication/vwLUAssets/The_changing_landscape_of_headquarter_locations_and_headquarter_taxation_of_Fortune_Global_500_companies/$FILE/CM1625.pdf, October 1, 2009.

[431] Sec. 7701(a)(4), (5).

anticipates using current Treasury regulations, with some modifications, for the purpose of allocation and apportionment of interest expense between currently taxed and noncurrently taxed foreign-source income. As to the pool of earnings considered not currently subject to U.S. tax, the proposal states that it would defer interest expense allocated and apportioned to a taxpayer's foreign source income that is not currently subject to U.S. tax, suggesting that the pool of applicable earnings includes both the earnings of CFCs and 10/50 companies attributable to the taxpayer.

Use of existing Treasury regulations for interest allocation and apportionment

The proposal places a greater emphasis on the location of borrowing and, arguably, would have a disproportionate effect on U.S. MNCs that have relatively high degrees of U.S. borrowing to fund offshore operations, most notably firms in the financial sector. Under present law, a U.S. MNC, all else being equal, can choose to locate its borrowing in the country where the interest expense deduction will produce the largest tax benefit, i.e., the country with the highest tax rate and the fewest restrictions on deductibility. As previously discussed, the fact that a U.S. MNC can claim a current U.S. tax deduction for borrowing to invest in low-taxed countries increases the after-tax return of those investments above their pre-tax returns, a result that some believe may encourage investments that would not otherwise be made.

The proposal arguably may result in an overcorrection, however, since the worldwide interest allocation rules do not take effect until 2021. As noted above, under present law, interest expense is generally allocated and apportioned based on the taxpayer's ratio of foreign or domestic (as applicable) assets to its worldwide assets, with all members of an affiliated group of corporations (excluding foreign corporations) treated as a single corporation for determining apportionment ratios.[432] As a result, the allocation under present law does not take into account the extent to which foreign members of the group may have borrowed outside the United States to finance their own operations. Instead, the present rules assume that debt incurred by U.S. group members funds the operations of foreign subsidiaries and may over-allocate interest expense to foreign-source income (an effect commonly referred to as "water's-edge fungibility"). The effect of these rules is to understate the taxpayer's foreign tax credit limitation in circumstances in which the taxpayer has significant borrowing at its foreign subsidiaries.[433]

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[432] Sec. 864(e)(2); Temp. Treas. Reg. sec. 1.861-9T.

[433] While the enactment of the worldwide interest allocation rules may be viewed as an attempt to correct for over-allocation of interest expense that may occur under the water's-edge approach by only allocating interest expense to foreign source income when debt at the U.S. group is treated as at least partially supporting the group's foreign operations, some may argue that even these rules may not always accomplish this goal. The computational approach under the worldwide interest allocation rules focuses on effective interest rates (interest expense divided by total assets) between the taxpayer's U.S. and foreign operations. While the excess of interest expense of the U.S. group over that of the foreign members of the group may be an indication that U.S. borrowings are supporting foreign operations, some note that such excess interest could be more a function of interest rate and foreign exchange rate differences. They may argue that a comparative leverage ratio approach which would test the leverage ratio (debt-to-assets) of the U.S. taxpayer to that of the foreign operations would better achieve an interest allocation that clearly reflects the U.S. debt used to fund foreign operations.

As the proposal is silent on the treatment of other provisions of the Code, it is reasonable to conclude that the proposal assumes that the worldwide interest allocation rules would take effect in 2021 as provided in present law. Until such time, however, the over allocation of interest expense to foreign source income under the present "water's edge" allocation rules would result in overstatement of the amount of interest expense subject to deferral − an effect that could be more costly than understatement of the foreign tax credit limitation if the taxpayer's offshore investments are located in relatively low-tax countries.

Opponents of the proposal argue that because such a large amount of interest expense may be properly allocated and apportioned to deferred foreign income under current Treasury regulations, not only debt, but also jobs may be shifted offshore. To the extent taxpayers can refinance their existing third-party obligations by replacing debt of the U.S. group with new debt at its CFCs, such a strategy may reduce the interest expense deferred under "water's edge" interest apportionment. Furthermore, to the extent a U.S. taxpayer's foreign asset ratio under the interest apportionment rules is expected to be significant, some contend that a taxpayer planning to build a new manufacturing facility may be compelled to finance and build the new facility overseas to avoid the increase to its cost of capital that may otherwise result from its inability to deduct currently the entire interest expense properly attributable to the expansion.[434] The ability and desire to pursue either course of action, however, may also be affected by nontax factors, including increased borrowing costs for foreign borrowing, the availability of cash flow to service such debt, access to qualified employees, proximity to suppliers, and proximity to customers.

The proposal contemplates that current Treasury regulations apply to determine the amount of a taxpayer's interest expense to be allocated and apportioned to foreign-source income. Although not explicitly stated, the proposal would seem to look to present-law regulations to determine the amount of such foreign-source interest expense to be allocated between currently taxed foreign-source income and noncurrently taxed foreign-source income. Applying the current Treasury regulations may be a logical approach given that the

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[434] Assume U.S. Parent, a multinational corporation, is planning to expand its manufacturing capacity by building a new plant. U.S. Parent's foreign asset percentage (i.e., U.S. parent's foreign assets as a percentage of worldwide assets) for purposes of apportioning interest expense is 40 percent and is entirely attributable to its investment in its foreign subsidiaries (i.e., no foreign branch assets or other foreign assets generating currently taxable foreign-source income). U.S. Parent is evaluating whether to build the new plant in the United States or to have one of its wholly owned foreign subsidiaries build the plant in the subsidiary's country of incorporation, which has a 25 percent tax rate. The expansion would be financed with $200 million of debt generating $10 million of interest expense annually, and the borrowing will occur in the jurisdiction where the expansion takes place. To the extent U.S. Parent builds the plant in the United States, $4 million of interest expense ($10 million of interest expense multiplied by 40-percent foreign asset ratio) may be deferred depending on the amount of overseas earnings U.S. Parent repatriates. If, however, the plant is built in the foreign subsidiary's country of incorporation, the interest expense may be currently deductible in its entirety. To the extent U.S. Parent has significant overseas earnings for which U.S. tax may continue to be deferred, a current deduction at a 25-percent tax rate may be preferable. This example, however, makes the simplifying assumption that the foreign asset ratio would remain unchanged as a result of the U.S. plant expansion, although it actually would be expected to decrease by some amount. To the extent the decrease in the foreign asset ratio is material, it may have a counterbalancing impact on this decision-making process.

methodologies therein are well known and would ensure consistency with the approach taken for sourcing interest expense for purposes of the foreign tax credit limitation.

Nonetheless, the proposal clearly anticipates changes to the existing regulations "as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income." This language suggests that the Administration believes that taxpayers may be engaging in strategies that, in Treasury's view, may under allocate interest expense to foreign-source income for purposes of determining the foreign tax credit limitation. To the extent that Congress acts on this proposal in a manner that contemplates use of the existing Treasury regulations, it may be appropriate at such time to perform a broader review of these regulations and modify them as necessary to help ensure they reach a result that is neither over- or under-inclusive when used to determine the interest expense attributable to deferred foreign income.

Inclusion of 10/50 company earnings

The proposal does not distinguish between the deferred foreign income of CFCs and that of 10/50 companies. Some may question the appropriateness of including the earnings of 10/50 companies because the U.S. shareholders of 10/50 companies are, by definition, minority shareholders that may have little control over the decision to repatriate earnings.[435]

Technical considerations

The proposal acknowledges that foreign-source income earned by a taxpayer through a branch as well as other directly earned foreign-source income, such as royalty income, is currently subject to U.S. tax. Therefore, the proposal does not apply to interest expense properly allocated and apportioned to such income. Allowing a current deduction for interest expense allocated to income subject to current U.S. taxation is appropriate as it follows the basic policy rationale of the proposal — to match the timing of expense recognition and income inclusion.[436]

The proposal does not explicitly address subapportionment of foreign-source income between foreign-source income that is currently subject to U.S. tax and income that is not currently subject to U.S. tax. However, this subapportionment may be accomplished with only minor modification to the current Treasury regulations. For example, once the taxpayer

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[435] The results of one study suggest that the participation of U.S. multinationals in joint ventures is sensitive to changes in U.S. tax rules as evidenced by the decline of U.S. investment in noncontrolled foreign affiliates when new limitations were added with respect to the crediting of foreign taxes paid by 10/50 companies. Mihir A. Desai and James R. Hines, Jr., "Basket cases: Tax incentives and international joint venture participation by American multinational firms," *Journal of Public Economics*, 71 (1999), 379-402. It is conceivable that the inclusion of 10/50 company earnings within the pool of noncurrently taxed income as proposed could have a similar result.

[436] For a detailed discussion of this issue and other technical concerns related to this proposal, see New York State Bar Association Tax Section, "Report on Administration Proposals Regarding Deferral of Deductions Related to Deferred Foreign Income, Foreign Tax Credit Pooling And Entity Classification Rules," 2009 *Tax Notes Today* 232-75 (December 4, 2009). See also Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady, John D. Bates, "Recent International Tax Proposals Raise Technical Issues," *Tax Notes* (August 3, 2009), pp. 451-70.

determines the amount of foreign-source interest expense that is attributable to its investment in includable foreign subsidiaries (i.e., CFCs and 10/50 companies to the extent applicable), such foreign-source interest expense could then be allocated between currently taxed foreign income and deferred foreign income based on a ratio of distributed to undistributed nonpreviously taxed earnings and profits ("E&P").

The proposal leaves certain technical questions unresolved. For example, the proposal does not address how foreign-source income on which U.S. tax is deferred should be computed. While the universe of foreign-source income on which U.S. tax is deferred for purposes of this proposal would presumably include the nonpreviously taxed earnings of a CFC or 10/50 company, it is unclear whether such nonpreviously taxed earnings would be determined on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately computed company results. Implicit in this question are technical issues such as the treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible as foreign subsidiary income not currently subject to tax, and the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries.[437]

Other technical considerations not addressed by the proposal include the need for currency translation rules for determining the nonpreviously taxed CFC and 10/50 corporation earnings on which U.S. tax is deferred, and whether the earnings of entities below the sixth tier that are not included in the section 902 qualified group should be excluded from the computation of foreign-source income on which U.S. tax is deferred.[438]

Tax reporting requirements would also necessarily increase under the proposal. Under present law, annual information reporting relating to E&P is required only with respect to CFCs. Under the proposal, however, the E&P of every CFC and 10/50 company could affect the computation of interest that must be deferred as a result of being attributable to foreign-source income not currently subject to U.S. tax, regardless of the amount of actual or deemed distributions. Thus, it likely will be necessary to provide for additional information reporting with respect to 10/50 companies so that the IRS can verify the accuracy of this computation.

Moreover, although E&P and foreign tax information with respect to 10/50 companies is already required under present law to compute deemed-paid credits, to apply the look-through

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[437] A related question is the treatment of income that would otherwise be foreign source but that is recharacterized under section 904(f) as U.S.-source income by virtue of the taxpayer having had an "overall foreign loss," or OFL, in an earlier year. If a taxpayer experiences an OFL for a taxable year, the taxpayer is required under section 904(f) to treat as U.S.-source income a portion (generally no more than 50 percent) of any foreign-source income earned in later years, to "recapture" the OFL. The effect is to reduce the taxpayer's foreign tax credit limitation in the subsequent years. The rationale for the recapture is that the OFL has offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S.-source income in that earlier year. The U.S. fisc would not be made whole when the taxpayer subsequently earned foreign-source income if the U.S. taxes on that income were completely offset by foreign tax credits.

[438] See sec. 902(b)(2)(B)(iii). Under present law, CFCs below the sixth tier of ownership (from the United States) are not considered part of the section 902 qualified group.

rules to dividends paid by 10/50 companies, and, in many cases, to apportion interest expense in calculating the foreign tax credit limitation,[439] this information can be difficult to obtain if U.S. shareholders do not control the company. Under existing Treasury regulations, a U.S. shareholder must track E&P and foreign tax information for a CFC or 10/50 company beginning only with the first taxable year in which the computation of E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder.[440] Under present law, this computation often is not significant until the controlling domestic shareholder is required to include income in respect of the CFC or 10/50 company. However, as E&P might be a key component in the computation of the interest deductions attributable to foreign-source income on which U.S. tax is deferred, this information could be significant under the proposal for all CFCs and 10/50 companies every tax year.

Prior Action

This proposal was included in the President's fiscal year 2011 budget proposal. Additionally, a similar proposal was included in the President's fiscal year 2010 budget proposal. The proposal included in the 2010 budget proposal would have applied more broadly to defer deductions for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax.

2. Determine the foreign tax credit on a pooling basis

Present Law

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. A foreign tax credit is available to provide relief from double taxation of income earned abroad. Subject to the limitations discussed below, a domestic corporation is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it

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[439] The Tax Reform Act of 1986 (Pub. L. No. 99-514) created a separate foreign tax credit limitation category for dividends from 10/50 companies. As enacted, this limitation applied on a corporation-by-corporation basis. The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added a new section 904(d)(4), which required that the foreign tax credit limitation applicable with respect to each 10/50 company be determined based on the underlying E&P from which the 10/50 company paid a dividend, for E&P accumulated in post-2002 taxable years. Any dividends paid during post-2002 years from E&P accumulated in pre-2003 years were, in general, assigned to a single 10/50 dividend basket, rather than to a separate basket for each 10/50 company as in the past. Section 904(d)(4) was then further modified by AJCA (Pub. L. No. 108-357) to extend look-through treatment to post-2002 dividends paid out of pre-2003 E&P.

[440] See Treas. Reg. sec. 1.964-1(c)(6), which generally provides that a foreign corporation that is a CFC or 10/50 company is not required to make an election to adopt a taxable year or method of accounting until the first taxable year in which the computation of its E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder(s). The regulation provides a list of events that are deemed significant for this purpose, including the shareholder's use of the tax book value method of interest expense apportionment and a distribution (either an actual dividend or a deemed dividend under subpart F) from the foreign corporation to its shareholders with respect to its stock.

pays or accrues. In addition, a domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid or accrued by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or is included in the domestic corporation's income under the provisions of subpart F.[441]

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax. In general, a foreign levy is considered a creditable tax if it is substantially equivalent to an income tax under U.S. tax principles. Under the present Treasury regulations, a foreign levy is considered a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and it is not compensation for a specific economic benefit provided by a foreign country.[442]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[443] This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding 10 taxable years.[444]

The U.S. foreign tax credit limitation provisions include rules that restrict availability of the credit in order to preserve the U.S. tax base. In its most restrictive (or theoretically purest) form, the limitation would function on an item-by-item basis, so that foreign tax imposed on any item of income could offset only the U.S. tax on that item. Historically, however, the limitation rules have operated instead with respect to more administrable groupings of similar items of income.[445]

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[441] Secs. 901, 902, 960. A similar rule applies under section 1293(f) with respect to income that is includible under the PFIC rules.

[442] Treas. Reg. sec. 1.901-2(a)(2)(i).

[443] Secs. 901, 904.

[444] Sec. 904(c).

[445] From 1986 through 2006, the foreign tax credit basket rules were significantly more restrictive than the present rules. Prior to 2007, income was assigned to eight separate baskets that were intended to group particular types of income thought to be taxed at similar effective foreign rates. A ninth basket (for dividends from noncontrolled section 902 corporations ("10/50 companies")) was repealed for post-2002 years. These rules replaced preexisting rules, in effect from 1976 to 1986, under which the foreign tax credit limitation was applied on

The present foreign tax credit limitation is generally applied separately for income in two different categories (often referred to as "baskets"), passive category income and general category income.[446] Passive category income generally includes investment income such as dividends, interest, rents, and royalties.[447] General category income is all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

Income that would otherwise constitute passive category income is treated as general category income if it is earned by a qualifying financial services entity (and certain other requirements are met).[448] Passive income is also treated as general category income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable).[449] Dividends (and subpart F inclusions), interest, rents, and royalties received from a controlled foreign corporation ("CFC") by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate basket by reference to the category of income out of which the dividend or other payment is made.[450] Dividends received by a 10-percent domestic corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.[451]

Under the present two-basket system, tax on income from a high-tax country in one basket can be credited against U.S. tax on income in the same basket derived in a low-tax jurisdiction. Moreover, the general basket encompasses a wide variety of types of active business income that may be taxed at different effective rates—even within the same country.

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an overall basis. During various periods prior to 1976, the limitation was applied on a foreign country by foreign country basis (the "per-country limitation"), an overall basis, or a combination of the two. Although the per-country limitation permitted cross-crediting of foreign taxes paid on different types of income from a single country, the effect was nonetheless generally more limited than permitted under present law due to general uniformity of tax bases and tax rates within a country.

[446] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., secs. 901(j), 904(d)(6), 904(h)(10), 865(h).

[447] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

[448] Sec. 904(d)(2)(C), (D).

[449] Sec. 904(d)(2)(F).

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

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

Description of Proposal

Under the proposal, a U.S. corporate taxpayer determines its deemed-paid foreign tax credit on a consolidated manner based on the aggregate foreign taxes and earnings and profits ("E&P") of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed-paid foreign tax credit (including lower-tier subsidiaries described in section 902(b)). The deemed-paid foreign tax credit for a taxable year is determined based on the amount of the consolidated E&P of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. The Secretary is granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

Background

If business income is taxed in the country in which it is derived (the source country), the residence country has two broad options for relieving potential double taxation on the foreign business income of its domestic taxpayers—exempt foreign-source income from home country taxation (an exemption or "territorial" system) or tax foreign-source income but provide a credit against home country taxation for foreign tax paid on that income (a "worldwide" system).[452] The United States has a worldwide system, although the U.S. tax on active foreign earnings derived through foreign subsidiaries is generally deferred until the earnings are repatriated in the form of a dividend distribution. As discussed above, the United States grants a credit (subject to limitations) for foreign taxes paid or accrued on foreign earnings, both directly by the U.S. taxpayer (for example, on the income of a foreign branch) and indirectly through a foreign subsidiary, to the extent the subsidiary's earnings are distributed or included in the U.S. shareholder's income under, for example, subpart F.[453]

The basic structure of the U.S. rules reflects several competing considerations. The first, reflected in the general rule of worldwide taxation and the granting of the foreign tax credit, is to ensure that a taxpayer's choice whether to invest in the home country or abroad is not affected by tax considerations. Thus, for instance, if the U.S. tax rules were completely neutral, those rules would not affect a U.S. multinational corporation's decision whether to invest in the United States or in a foreign jurisdiction.[454]

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[452] The majority of OECD countries have adopted some variation of an exemption system, though typically in combination with residence-based taxation of passive or highly mobile income. For additional discussion of exemption tax systems in other OECD countries, see the analysis of the Administration's proposal to defer deduction of interest expense related to deferred income in section V.C.1 of this document.

[453] Secs. 901, 902, 960.

[454] This comparison of neutrality between investments made in the United States to those made in a foreign jurisdiction is a capital export neutrality analysis. This type of analysis is often associated with worldwide taxation

Complete neutrality would require, however, both an unlimited foreign tax credit and full inclusion of all foreign earnings. Assume, for example, that a U.S. multinational corporation has operations in the United States and Country A. For simplicity, assume initially that the corporation carries out its Country A operations directly through a branch rather than through a CFC. The corporation has $1 million of U.S.-source income and $1 million of Country A-source income, for total worldwide income of $2 million. Assume the U.S. tax rate is 35 percent, and the Country A tax rate is 50 percent. The U.S. tentative tax liability, before taking into account the foreign tax credit, is $700,000 (35 percent of $2 million). The Country A tax liability is $500,000 (50 percent of $1 million). An unlimited foreign tax credit would allow the corporation a credit against its tentative U.S. tax liability for the entire $500,000 Country A tax. After this $500,000 credit, the corporation would pay $200,000 in U.S. tax and $500,000 in Country A tax, for a total tax liability of $700,000 on $2 million of worldwide income. As a result of this full foreign tax credit, the U.S. corporation would be subject to tax on its worldwide income at the U.S. 35-percent rate. The corporation would be in the same position it would have been in had its income been entirely U.S-source.

An unlimited foreign tax credit, however, would permit U.S. taxpayers to use the credit to offset U.S. tax on U.S., rather than foreign, source income. In the example above, the U.S. tax on Country A-source income is $350,000 (35 percent of $1 million). An unlimited foreign tax credit for the $500,000 of Country A tax would permit the corporation to eliminate this $350,000 of U.S. tax on Country A-source income and an additional $150,000 of U.S. tax on U.S.-source income. Stated differently, if the United States allowed an unlimited foreign tax credit, other countries could increase their tax rates on U.S. taxpayers' earnings in those countries without increasing those taxpayers' worldwide tax burdens; the only party made worse off would be the U.S. fisc. If, for instance, in the example above Country A raised its tax rate on U.S. corporations investing in Country A to 70 percent, the corporation with $1 million of Country A-source income would pay $700,000 of Country A tax, would eliminate entirely its U.S. tentative tax liability of $700,000, and would have $700,000 of worldwide (Country A) tax liability, the same amount of tax it would be liable for had it invested only in the United States.

The foreign tax credit limitation of present law preserves the U.S. tax base by allowing the foreign tax credit in broad terms to offset only U.S. tax on foreign-source income.[455] Thus, in the preceding example, present law permits the corporation to credit only $350,000 of Country A tax (the U.S. 35-percent tax rate multiplied by the corporation's $1 million of Country A-source income) against its tentative U.S. tax liability of $700,000. After the $350,000 foreign tax credit, the corporation has a worldwide tax liability of $850,000, comprised of $500,000 of Country A tax and $350,000 of U.S. tax. The corporation pays tax on its Country A-source

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of residents and the provision of a foreign tax credit. Two other neutrality models, capital import neutrality and capital ownership neutrality, are other common models used to evaluate international taxation. Under capital import neutrality, investment into a country from all other jurisdictions is taxed in the same manner and could be achieved if all countries had pure exemption systems. Under capital ownership neutrality, tax systems of countries around the world would not distort patterns of ownership of capital investments, and could be achieved if all countries either adopted pure worldwide systems or adopted pure exemption systems. See the discussion above on the Administration's Proposal to defer deduction of interest expense related to deferred income.

[455] See sec. 904.

income at the Country A tax rate—$500,000 of tax is 50 percent of $1 million of income—and its overall tax rate on its worldwide income, 42.5 percent, is higher than the 35-percent rate that would have applied if all of its income had been U.S.-source.

Given the absence of an unlimited foreign tax credit, a U.S. taxpayer that invests abroad in a high-tax jurisdiction may pay a higher rate of tax on its worldwide income than it would pay if it operated only in the United States. As discussed above, complete neutrality would require not only an unlimited foreign tax credit, but also that the foreign business income of U.S. taxpayers be subject to full U.S. taxation as the income is earned. In fact, however, U.S. taxation of foreign business income derived through foreign subsidiaries is generally delayed until the income is paid to the U.S. parent corporation, generally in the form of a dividend. A U.S. multinational corporation deriving income in a foreign jurisdiction effectively pays tax on that income at the foreign tax rate if it has the ability to keep the earnings offshore, indefinitely deferring U.S. tax. Thus, a taxpayer that invests abroad in a low-tax jurisdiction may pay a lower rate of tax on its worldwide income than it would pay if it operated only in the United States.

The basic construct of the U.S. international tax regime has remained the same since the 1960s. Three relatively new features of the current rules—the explicitly elective (or "check-the-box") entity classification rules promulgated in 1997, the CFC look-through rules enacted in 2006, and the existence of only two foreign tax credit limitation categories effective in 2007—facilitate the selective repatriation of both earnings and foreign taxes in a manner designed to increase available foreign tax credits after the operation of the foreign tax credit limitation. A simple strategy to reduce taxes by using foreign tax credits might involve, for example, repatriating highly-taxed foreign earnings and using credits generated by this highly-taxed income to offset U.S. tax on other lightly taxed foreign income (so-called "cross-crediting"). Taxpayers have also used more complex strategies to increase foreign tax credits. Such strategies include the use of hybrid entities to separate foreign tax credits from the related, deferred foreign-source income, or to create foreign tax credits with respect to income that is not taxable in the United States, and to use these credits to shelter other currently taxable foreign-source income.

Congress recently enacted legislation to combat some of these strategies.[456] This legislation included a provision (new section 909) that adopts a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income, new section 901(m) which denies a foreign tax credit for a portion of foreign income tax paid or accrued that relates to basis differences which result from certain foreign asset acquisitions, and new section 960(c) which limits the amount of foreign taxes deemed paid with respect to section 956 inclusions to the amount that would have been deemed paid if an actual distribution had been made. The recent legislation did not affect other structures, including the use of hybrid entities to avoid the anti-deferral rules in connection with certain foreign tax minimization strategies that enhance the benefits of deferral. Some commentators have argued that as a result of deferral and selective

[456] Pub. L. No. 111-226.

repatriation strategies, some U.S. taxpayers may have a lower worldwide tax burden than they would have if the United States adopted an exemption system.[457]

Overview

The proposal limits opportunities for selective cross-crediting of foreign subsidiary taxes by establishing mandatory cross-crediting for all foreign subsidiary taxes within the same foreign tax credit basket. In other words, by determining the amount of deemed-paid taxes under section 902 on an aggregate or blended basis, the proposal would require that foreign taxes imposed at high rates be used to offset potential U.S. tax liability on lower-taxed foreign earnings, without regard to the timing or source of any particular distribution of foreign earnings.

Specifically, the proposal would require a domestic corporation to determine the amount of foreign taxes that it is deemed to have paid under section 902 with respect to dividends received from a foreign subsidiary (and, correspondingly, under section 960 with respect to subpart F income inclusions) on an aggregate, rather than subsidiary-by-subsidiary, basis. Thus, a domestic corporation would be required to aggregate its proportionate share of the foreign taxes and the earnings and profits of all foreign subsidiaries with respect to which the domestic corporation may claim a deemed-paid foreign tax credit (including lower-tier subsidiaries described in section 902(b)).[458] Under the proposal, the amount of foreign taxes deemed paid in a taxable year would be computed by multiplying the corporation's proportionate share of foreign taxes by the ratio of the corporation's currently taxed income derived from its foreign subsidiaries (dividends and subpart F income inclusions for the current taxable year) and the sum of the domestic corporation's proportionate shares of the total earnings and profits of each foreign subsidiary. This computation would be performed separately for each foreign tax credit limitation basket.

Once the amount of foreign taxes that the domestic corporation is deemed to have paid is determined for each basket, the amount is added to the direct foreign taxes in the same basket. The foreign tax credit limitation (i.e., the amount of pre-credit U.S. tax payable with respect to income in the relevant basket) is then applied to the total amount of such foreign taxes, as under present law.

Under the proposal, therefore, the foreign taxes deemed paid with respect to dividends and subpart F income inclusions reflect the weighted average of the foreign tax rates paid by

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[457] See, e.g., Rosanne Altshuler and Harry Grubert, "Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," *National Tax Journal*, vol. LIV, no. 4 (December 2001), p. 16. The American Bar Association Task Force noted that the substantial cross-crediting permitted under existing law is one of several reasons why the U.S. tax rules are more generous to investment in high-tax countries than under an exemption regime; in particular, under an exemption system excess tax credits from high-tax countries cannot be used as credits against tax on other income. American Bar Association, "Report of the Task Force on International Tax Reform," reprinted in 59 *Tax Lawyer* 649, 775 (2006). ("American Bar Association Task Force Report").

[458] Thus, the proposal would extend to foreign taxes paid or accrued by 10/50 corporations as well as by CFCs.

each foreign subsidiary. Thus, a dividend paid to a U.S. parent by a subsidiary organized in a low-tax jurisdiction would typically carry deemed-paid foreign taxes in excess of the foreign taxes actually paid to that low-tax jurisdiction with respect to the distributed earnings. In contrast, a dividend paid to a U.S. parent by a subsidiary organized in a high-tax jurisdiction would typically carry deemed-paid foreign taxes in an amount that is less than the foreign taxes actually paid to that high-tax jurisdiction with respect to those earnings.

To illustrate this effect, consider a domestic corporation, Parent Co., that owns 100 percent of the shares of each of Alpha Co. and Bravo Co., CFCs organized in countries A and B, respectively. Alpha Co. has pre-tax earnings of $1,000 in the general basket, pays foreign taxes of $125 (a 12.5-percent tax rate), and has net E&P of $875. Bravo Co. also has pre-tax earnings of $1,000 in the general basket, but pays foreign taxes of $410 (a 41-percent tax rate) and has net E&P of $590. The aggregate amount of net E&P of Alpha Co. and Bravo Co. is $1,465 ($875 + $590),[459] and the aggregate amount of foreign taxes paid is $535 ($125 + $410).

Under present law, if Alpha Co. distributes $500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid would be $71 ($125 x ($500/$875)), but if the $500 distribution was made instead from Bravo Co., Parent Co. would be deemed to have paid $347 ($410 x $500/590). Under the proposal, Parent Co.'s decision regarding whether the $500 is remitted from Alpha Co. or Bravo Co. would not be influenced by the amount of foreign tax credits, as a $500 distribution from either Alpha Co. or Bravo Co. would result in a deemed-paid foreign tax amount to Parent Co. of $183 ($535 x ($500/$1,465)).[460]

Cross-crediting through selective repatriation

As described earlier, the present foreign tax credit limitation rules permit cross-crediting of foreign tax that is imposed at a rate higher than the applicable U.S. tax rate against residual U.S. tax on income in the same limitation basket that is subject to foreign tax at a rate lower than the U.S. rate. Historically, the U.S. foreign tax credit rules have restricted cross-crediting to varying degrees. The per-country limitation that applied in various forms prior to 1976, and the nine-basket regime that applied from 1986 through 2006, represented fairly stringent, although conceptually different, limitations on cross-crediting. The reduction in the number of baskets to two (passive and general) by AJCA increased the extent to which cross-crediting is feasible between income of different types and from different sources.[461] Consequently, planning to

[459] Undistributed earnings are reduced by the amount of foreign income taxes paid or accrued, whether or not those taxes are creditable. See Treas. Reg. sec. 1.902-1(a)(9)(iii) (post-1986 undistributed earnings are reduced for purposes of the analogous corporation-by-corporation computation under present law).

[460] The blended effective tax rate on Parent Co.'s share of the aggregate earnings of Alpha Co. and Bravo Co. is 26.8 percent ($535/($1,000 + $1,000)). Parent Co.'s deemed-paid foreign taxes of $183 on distributed earnings of $500 reflects that blended rate after the section 78 gross-up amount ($183), i.e., $183/($500 + $183) = 26.8 percent.

[461] The American Bar Association Task Force Report described the rules of present law as allowing "virtually unlimited cross-crediting, except with passive income." American Bar Association Task Force Report, p. 775.

maximize the use of foreign tax credits has assumed increasing importance in determining whether and when to repatriate foreign earnings.

Under present law, foreign tax credit planning typically involves selective repatriation of particular pools of foreign earnings, e.g., timing the repatriation of high-taxed income to coincide with the inclusion of low-taxed income. For example, excess foreign taxes (i.e., foreign taxes in excess of the U.S. 35-percent corporate rate), such as those arising in connection with the receipt of dividends from a foreign subsidiary in a high-tax jurisdiction, may be used to offset U.S. tax on royalties received for the use of intangible property in a low-tax jurisdiction. According to one study, even before AJCA took effect, almost two-thirds of all foreign-source royalties were sheltered by excess foreign tax credits in 2000, meaning that no residual U.S. tax was due.[462] In addition, multinational corporations engage in a variety of techniques that use the entity classification rules to direct the source of foreign earnings, the time at which the earnings are subject to U.S. tax, or the amount of associated foreign tax.

The proposal limits the benefits of selective repatriation strategies by disassociating the amount of deemed-paid foreign taxes from the amount of foreign tax[463] paid on the actual distributed earnings. Under the proposal, earnings distributed by a foreign subsidiary in any jurisdiction would carry deemed-paid foreign taxes at the average effective rate on all foreign earnings. In effect, the proposal requires universal cross-crediting of foreign taxes paid by foreign subsidiaries, both across countries and income type (within each basket) without regard to the timing of repatriation. Under the proposal, taxpayers would no longer be able to selectively cross-credit.

The overall policy objective to limit a taxpayer's ability to engage in cross-crediting is achieved by creating a blended effective tax rate for all earnings paid up by CFCs and 10/50 companies. Many of the provisions recently enacted were also targeted at reducing the ability of taxpayers to cross-credit; however, the enacted provisions were more narrowly focused than the proposal and operate to suspend or limit the foreign tax credits resulting from specific transactions.

The proposal represents a significant departure from traditional efforts to tailor limitation categories to be administrable yet sufficiently precise to approximate the results of an item-by-item limitation.[464] Instead, the proposal adopts a precisely opposite aggregation approach in an effort to make taxpayers indifferent (from a foreign tax credit perspective) as to the source from

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[462] Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," 11 (2006) Departmental Working Paper No. 200626, Department of Economics, Rutgers University, available at <ftp://snde.rutgers.edu/Rutgers/wp/2006-26.pdf>.

[463] As discussed above, some of these planning techniques are limited by the new foreign tax credit rules enacted recently. Pub. L. No. 111-226.

[464] The American Bar Association Task Force Report recommended either reverting to a per-country foreign tax credit limitation or grouping together countries with similar tax bases or effective tax rates. American Bar Association, Task Force Report, p. 775.

which foreign subsidiary earnings are repatriated and the time at which foreign subsidiary taxes are eligible to be claimed as a credit.

The proposal would not, however, eliminate opportunities for foreign tax credit planning. Because the proposal applies only for determining deemed-paid taxes creditable under section 902, incentives would still exist for structural planning to manage the effective tax rate of income earned through subsidiaries. Such planning could be designed to remove high-taxed foreign earnings from the blending regime, e.g., by converting foreign subsidiaries located in high-tax jurisdictions into branches or partnerships, so that foreign taxes associated with those earnings would be considered directly paid taxes under section 901 rather than section 902. Alternatively, taxpayers could plan to remove low-taxed earnings from the blending regime, e.g., by placing low-taxed subsidiaries below the sixth-tier foreign corporations described in section 902(b)(2).

Under present law, sections 902 and 78 establish parity between the treatment of foreign taxes paid with respect to branch income and those paid with respect to income earned through foreign subsidiaries. Foreign-source income earned through a foreign branch is fully includible by a domestic corporation, without reduction for foreign taxes paid on that income, and the full pre-tax amount is reflected in the section 904 limitation fraction. The amount of foreign-source income earned through a foreign subsidiary that can be distributed as a dividend for U.S. tax purposes (and thus can actually be received by a domestic corporation) will necessarily be an after-tax amount, i.e., earnings reduced by the amount of the foreign taxes paid by the subsidiary on those earnings.[465] Section 78 requires, however, that a domestic corporation claiming a foreign tax credit under section 902 include, as additional dividend income, an amount equal to the foreign taxes that it is deemed to have paid under section 902 (or section 960). This section 78 "gross-up" ensures that the full amount of the earnings on which the foreign taxes were paid is reflected in the calculation of the section 904 limitation. The result parallels the treatment of income earned through a branch, which is fully includible in income without reduction for foreign taxes.

Under the proposal, however, foreign taxes paid by a foreign branch would be fully available for credit, subject only to the section 904 limitations applicable to general category income and passive category income, while foreign taxes paid by a foreign subsidiary would be creditable only to the extent of the average effective foreign tax rate (determined by taking into account all foreign subsidiaries). The section 78 gross-up mechanism provides parity in the computation of taxable income earned through a branch and through a subsidiary, but does not address this timing disparity. Consequently, U.S. corporate taxpayers may have an incentive to earn high-taxed foreign-source income through a branch rather than a subsidiary. The result may be to encourage the conversion of existing subsidiaries into branch form, or the establishment of new branches rather than new subsidiaries in countries with relatively high foreign tax rates. To the extent that a domestic corporation is able to place high-taxed foreign-source income in branches, it could be expected that any foreign-source income remaining in its foreign subsidiaries will be subject to a relatively lower foreign tax rate. Over time, the foreign taxes

[465] The amount that can be paid out as a distribution is determined under foreign law, but the amount of the distribution that is a dividend is determined under U.S. law.

associated with undistributed foreign subsidiary income could diminish, increasing the expected U.S. tax liability associated with repatriation of that income and, thus, the disincentive to repatriation. Such an effect should be considered in conjunction with the Administration's proposal to "Defer Deduction of Interest Expense Related to Deferred Income," which is intended to encourage repatriation of foreign earnings.

Technical and administrative considerations

The proposal does not resolve a number of additional technical and administrative matters, which will need to be addressed either by statute or by regulation. Most importantly, it would be necessary to develop rules for allocating subsidiary earnings and foreign taxes proportionally among multiple shareholders (direct and indirect), including in situations in which shareholders' proportionate interests change as a result of acquisitions, dispositions, dilutions, mergers, and other corporate events. Addressing these events would likely require the establishment of shareholder-level accounts to which the earnings and foreign taxes of a foreign subsidiary would be allocated annually, based on the shareholder's proportionate ownership of the subsidiary during the year. The rules would need to consider the treatment of the accounts upon a change in ownership of the shares.[466]

Another significant consideration is the manner in which the pools of foreign subsidiary earnings would be determined: whether on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately computed company results. Implicit in this question are technical considerations such as: (1) the treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible in the aggregate pool of earnings; (2) the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries; (3) ordering rules for determining the extent to which an earnings deficit in one basket should reduce positive earnings in another basket of the same foreign subsidiary or other foreign subsidiaries; and (4) whether the amount and separate limitation character of dividends and subpart F inclusions should be determined by reference to the aggregate blended E&P pool or on a separate-entity basis.

Additional technical considerations include: (1) integration of the proposal with the rules of section 905(c) addressing foreign tax redeterminations; (2) currency translation rules for determining the amounts included in the blended pools of foreign taxes and foreign earnings, and for translating into U.S. dollars and computing exchange gain or loss on distributions from those blended pools; (3) treatment of foreign earnings and foreign taxes in foreign subsidiaries below the sixth-tier that are not included in the section 902 qualified group;[467] (4) the interaction

[466] Under section 1248, gain recognized on a transfer of shares of a CFC by a 10-percent U.S. shareholder is generally treated as a dividend, to the extent of the accumulated earnings of the CFC attributable to those shares during the shareholder's holding period. Under section 902, as modified by the proposal, such a dividend would carry with it a proportional amount of the foreign taxes in the shareholder's account. Any earnings and foreign taxes remaining in the account, e.g., as a result of the application of the gain limitation to the amount treated as a dividend under section 1248, could be either added to the new shareholder's earnings and foreign tax accounts or eliminated.

[467] See sec. 902(b)(2)(B)(iii). Under present law, CFCs below the sixth tier of ownership (from the United States) are not considered part of the section 902 qualified group.

between the rules for determining the taxable distribution under sections 301 and 302, under which E&P is determined on an entity-by-entity basis, and the proposal's determination of the available foreign tax credit, under which E&P is determined on an aggregate basis; and (5) whether the available foreign tax credit for a particular taxable year (before application of the section 904 limitation) is determined on the basis of a single, carryforward calculation.

Tax reporting requirements would also necessarily increase under the proposal. Under present law, annual information reporting relating to E&P and foreign taxes is required only with respect to CFCs. Under the proposal, however, every foreign subsidiary's E&P and foreign taxes would affect the current year section 902 credit of the U.S. parent corporation, regardless of the amount of actual or deemed distributions from that subsidiary. Thus, it will likely be necessary to provide for additional information reporting with respect to 10/50 corporations so that the IRS can verify the amount of section 902 credits claimed on taxpayers' returns.

Moreover, although E&P and foreign tax information with respect to 10/50 corporations is required under present law to compute deemed-paid credits, apply the look-through rules to dividends paid by 10/50 corporations, and, in many cases, to apportion interest expense in calculating the foreign tax credit limitation, this information can be difficult to obtain if U.S. shareholders do not control the company. Under existing Treasury regulations, a U.S. shareholder must maintain E&P and foreign tax information for a CFC or 10/50 corporation beginning only with the first taxable year in which the computation of E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder.[468] Under present law, this information often is not significant until the controlling domestic shareholder is required to include income in respect of the CFC or 10/50 corporation. Under the proposal, however, this information would likely be significant for all CFCs and 10/50 corporations each taxable year.

Transition considerations

The proposal does not specify a transition rule. If the proposal is enacted without providing for a transition rule for pre-enactment foreign taxes and earnings and profits, all foreign taxes and all earnings of foreign subsidiaries, including amounts attributable to periods prior to the enactment of the proposal, would be subject to the blending rule. Such an approach would be simpler than an approach requiring separate tracking and disparate treatment of pre- and post-effective date earnings and taxes pools. However, complex rules could still be required for merging earnings and taxes accounts of foreign subsidiaries acquired by U.S. shareholders and subject to the pooling rules on different dates, or for foreign subsidiaries that presently maintain layered earnings and taxes accounts resulting from pre-effective date merger and acquisition activity.

[468] Treas. Reg. sec. 1.964-1(c)(6). The regulation provides a list of events that are deemed significant for this purpose, including the shareholder's use of the tax book value method of interest expense apportionment and a distribution (either an actual dividend or a deemed dividend under subpart F) from the foreign corporation to its shareholders with respect to its stock.

An alternative approach, similar to that adopted with respect to the section 902 amendments made by the Tax Reform Act of 1986[469] (establishing the multi-year pooling rules), would be to establish separate pools of pre- and post-enactment date foreign taxes and earnings. This approach would require ongoing maintenance of separate pre- and post-effective date earnings and foreign tax accounts and, by implication, two sets of foreign tax credit rules. It would also require a dividend ordering rule for determining the amount of any dividend paid from pre-effective date earnings versus the amount paid from post-effective date earnings.[470]

Treaty considerations

It is conceivable that U.S. income tax treaty partners and commentators may argue that the proposal is inconsistent with the U.S. obligations under the relief from double taxation provisions of its income tax treaties.[471] Such provisions generally require the United States to relieve double taxation by allowing its citizens and residents a credit against U.S. income tax liability for income tax paid or accrued directly by those citizens or residents to the other treaty country. Typical U.S. tax treaties also require the United States to allow a domestic corporation that owns at least 10 percent of the voting stock of a corporation resident in the other treaty country that receives dividends from the other corporation a credit (an "indirect credit") against U.S. tax for the tax that the other corporation pays to the other treaty country with respect to the profits out of which such dividends are paid.[472]

As described earlier, in situations in which the domestic corporation is a 10-percent-or-greater shareholder in two or more foreign corporations located in different countries with different effective tax rates, the amount of foreign taxes that a domestic corporation would be deemed to have paid under the proposal with respect to distributed earnings of a foreign subsidiary may not correspond directly to the amount of taxes paid by the subsidiary on those earnings. Rather, the amount of taxes deemed paid would reflect a weighted average of the effective tax rates paid by each of those subsidiaries. Thus, in the case of a foreign subsidiary located in a country with a relatively high tax rate, the amount of taxes deemed paid by the U.S. corporation could be lower than the amount actually paid by the subsidiary on the distributed earnings. Conversely, in the case of a foreign subsidiary located in a country with a relatively low tax rate, the amount of taxes deemed paid by the U.S. corporation could be higher than the amount actually paid by the subsidiary on the distributed earnings. Either case raises a question

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

[470] See, e.g., Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," *National Tax Journal,* 54, p. 784, suggesting this approach in connection with transitioning to an exemption system and noting that precedent is found in the rules applicable to C corporations that elect subchapter S status and in the transition rules adopted in 1986 in connection with the modifications to the foreign tax credit limitation rules.

[471] See, Robert H. Dilworth, "Proposed Multilateral FTC Pooling and U.S. Bilateral Tax Treaties," *Tax Notes* (September 21, 2009).

[472] U.S. Treasury Department, United States Model Income Tax Convention of November 15, 2006, Article 23 (Relief from Double Taxation). Most U.S. income tax treaties include essentially the same language.

as to whether the foreign tax credit allowed as a result of the proposal is strictly consistent with a treaty's relief from double tax requirement that credit be allowed for "the" income tax paid to the treaty country in question. In particular, a treaty country whose income tax rate is relatively high may argue that the disassociation of the deemed-paid tax amount from the amount of tax actually paid or accrued by the subsidiary to that treaty country on the distributed earnings is a violation of the treaty.

In cases in which potential technical arguments could allege the existence of a conflict between U.S. domestic law and U.S. treaties, there is precedent for providing an express treaty override to forestall litigation.[473] In the absence of an express treaty override, the legislation would be expected to take precedence over an income tax treaty based on the "last-in-time" principle if the proposal were not consistent with the treaty's relief from double taxation requirements.[474]

The proposal may be viewed as consistent with U.S. treaty obligations because it does not deny a foreign tax credit for the full amount of foreign taxes paid on earnings distributed from higher-tax countries. Rather, in the case of foreign taxes paid at a relatively high rate (i.e., a rate higher than the weighted average rate paid by all of the domestic corporation's subsidiaries), the effect of the proposal is to defer the availability of the full credit until all earnings, in the aggregate, have been distributed to the domestic corporation by its foreign subsidiaries. In this respect, the proposal is somewhat similar to the foreign tax credit limitation rules of section 904, which are expressly contemplated by U.S. income tax treaties. The purpose of the section 904 rules is to limit the extent to which foreign taxes may be credited in a particular year to ensure that U.S. tax on U.S.-source income is not offset by direct and deemed-paid credits, as well as to mitigate cross-crediting across different types of foreign-source income. The rules do not deny a foreign tax credit to the extent that taxes in excess of the current year limitation can be used in a carryforward or carryback year.

On the other hand, the proposal would function differently from the section 904 limitation in the sense that section 904 restricts a taxpayer's ability to credit one country's tax against U.S. income tax on *other income* (i.e., income other than the income on which that tax was paid). In contrast, the proposal would limit a domestic corporation's ability to credit foreign tax against the U.S. income tax imposed on the *same income* on which the foreign tax was paid, which some treaty partners may view as a conflict with the U.S. treaty obligations.

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[473] See, e.g., Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647), Section 1012(aa)(2)(A). This provision expressly resolved several such conflicts that arose from the Tax Reform Act of 1986 (Pub. L. No. 99-514), including a treaty override provision with respect to the section 904(d) limitation categories. See also Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987* (H.R. 2636 and S. 1350) (JCS 15-87), June 15, 1987, p. 320. The Joint Committee staff noted that prior legislation, such as the Revenue Act of 1962 (Pub. L. No. 87-834), had expressly provided an override of prior treaty obligations to forestall any possible litigation.

[474] Sec. 7852(d)(1).

The effect of the proposal on a particular domestic corporation would vary depending on the locations of its foreign subsidiaries, their relative sizes, and the extent to which the domestic corporation chooses to repatriate each subsidiary's earnings.

Other considerations

Some argue that this proposal to determine the foreign tax credit on a pooling basis will only exacerbate the competitive disadvantages they view as inherent in the U.S. international tax system. They argue that the United States is an outlier as one of the few OECD countries that has retained a worldwide tax regime.[475] They argue that under present law, the existence of a residual U.S. tax liability, even if deferred, reduces after-tax returns from offshore investments below that obtained by foreign-based MNCs. They claim that the lower after-tax return places U.S. MNCs at a competitive disadvantage in developing or expanding foreign markets. To the extent that the proposal increases the tax rate on foreign earnings, a U.S. MNC's residual tax liability on active foreign business earnings increases, further reducing after tax returns to investment abroad.

Others challenge the general assertion that there is a competitive disadvantage inherent in the U.S. international tax system. They argue that that there is no empirical evidence of such a competitive disadvantage and that such claims are questionable given the success of many U.S. businesses overseas. Moreover, if there are issues of competitiveness in certain U.S. industries, they may challenge the assertion that the issues are attributable to the U.S. international tax system rather than labor cost differentials, product quality differences, regulatory differences, and other nontax factors.[476] Additionally, proponents of the proposal argue that the U.S. international tax system provides a competitive advantage to U.S. MNCs over their U.S. competitors by creating an incentive to move jobs and business operations overseas.[477] See the discussion above on the Administration's Proposal to "Defer deduction of interest expense related to deferred income," for a more detailed discussion of the arguments.

Prior Action

The President's fiscal year 2011 budget contained a substantially similar provision.

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[475] Only seven other OECD countries, Chile, Greece, Ireland, Israel, Korea, Mexico, and Poland, currently have worldwide tax system. These seven jurisdictions have significantly less outbound foreign direct investment and relatively lower statutory corporate tax rates as compared to the United States.

[476] J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (December 7, 2009), p.1086.

[477] Alison Bennett, "Support for Stand-Alone Use of International Budget Provisions Continues, Sperling Says," *The Bureau of National Affairs, Inc. Daily Tax Report,* April 22, 2010, 76 DTR G-6.

3. Tax currently excess returns associated with transfers of intangibles offshore

Present Law and Background

In general

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Subject to certain limitations, a domestic corporation is allowed to claim a credit against its U.S. income tax liability for foreign taxes paid. The foreign tax credit provides relief from double taxation.

Income earned directly or through a pass-through entity (such as a partnership) is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a dividend distribution of those earnings to the U.S. person. This ability of U.S. persons to defer income is circumscribed by various regimes intended to restrict or eliminate tax deferral with respect to certain categories of passive or highly mobile income. The controlled foreign corporation ("CFC") rules under subpart F[478] limit tax deferral with respect to certain categories of passive or highly mobile income.

The United States also has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a foreign controlled party through inappropriate pricing of related party transactions. The statutory authority for those rules is found in section 482, and the principal measure by which that authority is exercised is the arm's-length standard.[479]

Foreign tax credit

A domestic corporation is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays, subject to certain limitations. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid or accrued by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under subpart F.[480]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability otherwise due on its foreign-source taxable income (as determined under U.S. tax accounting principles). This

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[478] See secs. 951-965.

[479] Treas. Reg. sec. 1.482-1.

[480] Secs. 901, 902, and 960. A similar rule applies under section 1293(f) with respect to income that is includible under the passive foreign investment corporations ("PFIC") rules.

limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[481]

Historically, the U.S. foreign tax credit limitation provisions have included various alternative approaches to limiting cross-crediting in order to preserve the U.S. tax base.[482] Presently, the foreign tax credit limitation regime applies separately for income in two different categories (referred to as "baskets"), passive category income and general category income.[483] Passive category income generally includes (with certain exceptions, including when income is earned as part of an active business) investment income such as dividends, interest, rents, and royalties.[484] General category income is all income that is not in the passive income category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one category cannot be used to offset U.S. tax on income in the other category.

Subpart F inclusions of a United States shareholder are assigned to the appropriate separate limitation category by reference to the category of income out of which the dividend or other payment was made.[485] Under the present two-basket system, general category income of different types or from different countries may be credited against other general category income. Thus, foreign tax on income from a high-tax country in one category can be credited against U.S. tax otherwise due on income in the same category derived in a low-tax jurisdiction.

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[481] Secs. 901 and 904.

[482] From 1921 through 1962, there were no "baskets." In 1962, a separate basket was added for certain interest income. Revenue Act of 1962, Pub. L. No. 87-834, sec. 10. Separate baskets for certain foreign-source oil related income were added in 1975. Tax Reduction Act of 1975, Pub. L. No. 94-12, sec. 601(a). An elaborate basketing system was added by the Tax Reform Act of 1986, pursuant to which nine separate baskets were provided for items such as passive income, financial service income, and shipping income. Pub. L. No. 99-514, sec. 1201. In addition to separate basketing by income category, from 1932 until 1954, the foreign tax credit was subject to the lesser of an overall limitation or a per-country limitation. 1932 Revenue Act, Pub. L. No. 72-154, sec. 131(b)(1). From 1954 until 1960, the credit was subject to only a per-country limitation. Internal Revenue Code of 1954, Pub. L. No. 83-591, sec. 904(a). During the period from 1960 to 1975, taxpayers could choose whichever of the two limitations (overall or per-country) was more favorable. Pub. L. No. 86-780, sec. [1](a). The per-country limitation was repealed in 1976. Pub. L. No. 94-445, sec. 1031(a).

[483] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other Code sections. See, e.g., secs. 865(h), 901(j), and 904(h)(10).

[484] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain domestic international sales corporations and foreign sales corporations.

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

Subpart F

Under the subpart F rules, a 10 percent-or-greater U.S. shareholder ("United States shareholder") of a CFC is subject to U.S. tax currently on its pro rata share of certain income earned by the CFC, whether or not such income is distributed to the shareholder. A CFC is defined generally as a foreign corporation with respect to which United States shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation. Income subject to current inclusion under subpart F includes foreign base company income.[486] Foreign base company income includes foreign personal holding company income,[487] foreign base company sales income,[488] and foreign base company services income.[489]

Foreign personal holding company income

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts. There are several exceptions to the general rule of current taxation on foreign personal holding company income.[490]

Foreign base company sales income

Foreign base company sales income generally consists of income derived by a CFC in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both manufactured outside the CFC's country of incorporation and sold for use outside of that same country for the income from its sale to be considered foreign base company sales income.[491] Certain exceptions to this general rule may apply. For example, income from sales of property involving a related person may be excluded under section 954(d) if a prescribed manufacturing exception applies.

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[486] Sec. 952(a).

[487] Sec. 954(a)(1).

[488] Sec. 954(a)(2).

[489] Sec. 954(a)(3); see also sec. 954(a)(5) (foreign base company oil related income).

[490] For example, the exception for active financing income (secs. 953 and 954).

[491] Sec. 954(d)(1).

Foreign base company services income

Foreign base company services income generally consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related party,[492] including cases where substantial assistance contributing to the performance of services by a CFC has been furnished by a related person or persons.[493] Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person or persons to the CFC if the assistance satisfies an objective cost test. For purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related U.S. person to a CFC. The objective cost test is satisfied if the cost to the CFC of the assistance furnished by the related U.S. person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.[494]

Pricing for transfers between related persons

The United States has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a related foreign company through aggressive transfer pricing that does not reflect an arm's-length result. Similarly, the domestic laws of most U.S. trading partners include rules on transfer pricing.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate. Thus, the regulations generally attempt to determine the respective amounts of profits of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length.

There is an additional test for transactions resulting in the transfer of intangible property, which provides that the income with respect to any transfer (or license) of certain intangible property to a related person must be commensurate with the income attributable to the intangible property.[495] Section 367(d) provides a related rule under which compensation, in the form of an

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[492] Sec. 954(e).

[493] Treas. Reg. sec. 1.954-4(b)(1)(iv).

[494] IRS Notice 2007-13, 2007-5 C.B. 410. Prior to the issuance of Notice 2007-13, the substantial assistance rules also included a subjective principal element test. Under the subjective principal element test, assistance in the form of direction, supervision, services or know-how were considered substantial if the assistance provided the CFC with skills which where were a principal element in producing the income from the performance of such services by the CFC.

[495] Sec. 482.

imputed royalty stream, is required for an outbound transfer of intangible property in the context of an otherwise nontaxable reorganization transaction.[496]

Description of Proposal

The proposal provides that if a U.S. person transfers (directly or indirectly) an intangible from the United States to a related CFC (a "covered intangible"), then certain excess income from transactions connected with or benefiting from the covered intangible are treated as subpart F income if the income is subject to a low foreign effective tax rate. For this purpose, excess intangible income is defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. For purposes of this proposal, the transfer of an intangible includes by sale, lease, license, or through any shared risk or development agreement (including any cost sharing arrangement). Under the proposal, this subpart F income is a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under section 904.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

Policy rationale

Overview

The proposal seeks to reduce the financial incentive for transferring intangible property to a low-tax CFC. The policy concern is that such transfers have shifted income outside of the United States that would otherwise be subject to U.S. tax, resulting in erosion of the U.S. tax base.[497] Transfer pricing rules provide a mechanism for protecting the U.S. tax base from artificial income shifting. However, the potential financial incentives of certain related-party transactions (particularly the financial incentives from those transactions involving transfers of intangible property to low-tax CFCs) have put significant pressure on the enforcement and effective application of transfer pricing rules. The Administration believes that the expansion of subpart F to require current taxation of excess intangible income may reduce the incentive for taxpayers to engage in these transactions. The net effect of the proposal may approximate the tax consequences of retaining the intangible property in the United States as it eliminates deferral of U.S. taxation on income from intangible property transactions in excess of an established return on costs.

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[496] For a detailed discussion of transfer pricing concepts, see the Present Law section of Part V.C.4 (Limit shifting of income through intangible property pransfers) in this document.

[497] For additional discussion and an analysis of case studies that illustrate possible income shifting transactions, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

Some may argue that this punitive approach may encourage multinational corporations to locate activities that produce high-value intangible assets offshore from the beginning of the development process rather than to risk the application of this provision when the resulting intangible property is transferred for use in foreign markets. Rather, they may argue that the United States should create new incentives to encourage the production and location of high-value intangibles in the United States. This approach may be viewed as more in line with U.S. policies such as the research credit or the current deduction available for research and development expenses and could be accomplished by providing a favorable rate or tax regime for intangible property developed or located in the United States.[498]

Minimum threshold of taxation as the prerequisite for deferral

The proposal increases the U.S. tax liability of affected taxpayers because it denies deferral for certain active business earnings that have previously enjoyed deferral from U.S. tax. The proposal could be viewed as effectively establishing a base foreign-tax threshold for deferral, such that certain foreign earnings that do not bear some minimum threshold level of source taxation are taxed currently in the United States.[499] Although views differ, it has been observed that the U.S. deferral system approximates the exemption regimes of U.S. trading partners, thereby leveling the competitive landscape for U.S. companies in the global economy.[500] Arguably, the additional limitations on deferral that the proposal imposes may reduce the ability of some U.S. companies to compete against foreign rivals, raising the question whether the proposal fits better within a broader approach to overall tax reform.[501]

The proposal includes a requirement that the excess income be computed with regard to a connection or benefit from the transferred intangible. However, even with this requirement, the proposal does not distinguish between transfers of high-value intangible property and other types of intangible property that may be connected with the measured gross income. For example, if a CFC directly acquires a patent from an unrelated party (a transfer that is outside the scope of the

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[498] Some countries have such favorable tax regimes, sometimes referred to as patent or innovation "boxes," related to certain types of intellectual property. For example, the Netherlands has a regime that effectively taxes income from qualifying profits at a five percent tax rate. The United Kingdom is considering a patent box regime that would apply a preferential 10 percent corporate income tax on income from patents or patented products. See Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (JCX-33-11), May 20, 2011 for a brief discussion of these regimes.

[499] The concept of taxing income that is subject to a low foreign tax rate under this proposal would not be unique to the U.S. tax system. Several countries with dividend exemption systems have rules that either deny the exemption for dividends paid from low-taxed earnings, or provide for current taxation of low-taxed earnings under CFC rules existing in those countries.

[500] See, e.g., Office of Tax Policy, Department of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," (December 2000): *Preamble*, p. x; Joint Committee on Taxation, *Options To Improve Tax Compliance And Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 188.

[501] For discussion of different perspectives on the competitive implications of the Administration's proposals, see the Analysis section of Part V.C.1 (Defer Deduction of Interest Expense Related to Deferred Income) in this document.

proposal) for a process that revolutionizes widget manufacturing and significantly reduces its cost of goods sold, but the CFC also uses other manufacturing know-how[502] that is important—but not nearly as valuable—the CFC may enjoy a high rate of return that is primarily derived from the patented process. However, if the other manufacturing know-how is transferred to the CFC by a related U.S. person, the CFC may be subject to testing—and possible current taxation—under the proposal.

No direct changes to the arm's-length standard

Transfer pricing issues are among the more significant faced by the IRS in its tax administration efforts.[503] Among the difficulties is the intensive case-by-case intervention required to resolve factual disputes in transfer pricing cases. Although the effectiveness of the arm's-length standard as the measure of transfer prices is sometimes debated,[504] the proposal avoids this debate by addressing excessive income shifting through subpart F, rather than through any direct changes to the transfer pricing rules of section 482. To the extent the proposal avoids changing transfer pricing rules, proponents may view it as complementing section 482 and providing a targeted anti-abuse rule.

A rationale for taking this approach, rather than modifying the arm's-length standard,[505] is that such a modification could be criticized as disruptive to relations with U.S. trading partners.[506] Following the leadership of the United States, most countries (including all of the

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[502] If the manufacturing know-how is related to efficiency in a routine manufacturing process that most manufacturers develop over time through experience, and comparable transactions are readily available to establish an arm's-length price, the manufacturing know-how may be "routine intangible property." In contrast, the manufacturing know-how of a large team of engineers and skilled craftsmen assembled for purposes of developing or perfecting a complex manufacturing process that no other company is capable of repeating independently is likely not routine intangible property, as there are not comparable transactions readily available to establish an arm's-length price. See generally "White Paper," pp. 488-490.

[503] See, e.g., Prepared remarks of Douglas H. Shulman, George Washington University Law School, *22ND Annual Institute on Current Issues on International Taxation*, Washington, D.C., IR-2006-116 (December 10, 2009); Randall Jackson, "Increased Efficiency, Transfer Pricing Pilot Cases Top LMSB Agenda, Official Says," *Tax Notes Today,* 71-9 (April 14, 2010).

[504] See, e.g., Marie Sapirie, "Arm's-Length Standard Contested at Ways and Means Hearing," *Tax Notes Today,* 141-2 (July 23, 2010) (reporting the remarks of Stephen Shay, Deputy Assistant Secretary for International Tax Affairs, U.S. Treasury Department); Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes* 30 (February 17, 1986), p. 625; Michael C. Durst, "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws," *Tax Notes International* 57 (January 18, 2010), p. 247.

[505] For a discussion of the history of the arm's-length standard, which dates back to 1935, see Rueven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," *Virginia Tax Review* 15 (hereafter "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation"): p. 89; see also "White Paper," pp. 459-461.

[506] This outcome was the case when Congress adopted the second sentence of section 482, which requires the use of hindsight (through analysis of actual profit experience) in making section 482 adjustments with respect to income derived from the transfer of intangible property. Pub. L. No. 99-514 (October 22, 1986). Although the legislative history to the Tax Reform Act of 1986 did not address the relationship between the commensurate-with-income principle and the arm's-length standard, many commentators viewed the new provision as overriding the

member countries of the Organisation of Economic Co-operation and Development, the "OECD") adopted and now follow the arm's-length standard.[507]

Another view of the proposal is that it is consistent with the arm's-length standard, but serves indirectly to reduce the importance of risk in determining comparability. Some have argued that accounting for assignment of risk in transactions between related parties is a weak point in the arm's-length standard.[508] Arguably, transfers to related parties normally do not involve the bona fide shifting of economic risk that would occur in transactions between unrelated parties. This is because the separate existence of each company in the group is respected; therefore, risk can be assigned by contract to any member of the group with the objective ability to bear that risk, even though risk does not leave the affiliated group.

Outbound transfers of intangible property tend to be accompanied by assignment of risk related to the commercialization of the intangible property transferred. These concurrent transfers of intangible property and risk to the CFC highlight that risk (and the associated profit) is very mobile.[509] Mobility of income is addressed under present law by the subpart F rules, which are designed to prevent the diversion of certain income (including both passive and mobile income) from U.S. taxation. The proposal adopts the mechanics of subpart F to tax currently the mobile profits associated with assigned risk.[510]

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arm's-length standard. See, e.g., Marc M. Levey and Stanley C. Ruchelman, "Section 482—The Super Royalty Provisions Adopt the Commensurate Standard," *Tax Lawyer* 41 (Spring 1988), p. 611; E.C. Lashbrooke, Jr., "I.R.C. §482 Commensurate with Income Standard for Transfers of Intangibles," *DePaul Business Law Journal* 1 (1989), pp. 183, 186; W. Scott McShan, Michael J. Merwin, Garry B. Stone, and Delores R. Wright, "Section 482 White Paper . . . A Review of Third-Party License Agreements: Are Periodic Adjustments Arm's Length?" *Tax Executive* 41 (July-August 1989), p. 353. In contrast, Treasury and the IRS characterized this requirement as a clarification of prior law, concluding that it is consistent with the arm's-length standard. "White Paper," p. 472. This conclusion may have been influenced by the "strong objections by our trading partners to the language contained in the 1986 legislative history advocating abandonment of the [arm's-length standard]," as well as concerns expressed by U.S. taxpayers that deviating from the arm's-length standard would be inconsistent with international norms and would increase the possibility of double taxation. "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," p. 133.

[507] White Paper, p. 475.

[508] See, e.g., Robert H. Dilworth, "Tax Reform: International Tax Issues and Some Proposals," *International Tax Journal* (January - February 2009), pp. 5, 94 and Michael Durst, "Congress Fix Transfer Pricing and Protect U.S. Competitiveness," *Tax Notes* 128 (July 26, 2010), pp. 401, 403.

[509] See Kristen Parillo, "Obama Administration Still Vigilant on Check the Box," *Tax Notes Today*, 56-2 (March 24, 2010) (reporting the remarks of Manal Corwin, International Tax Counsel, U.S. Treasury Department); Kristen Parillo, "Intangible Asset Proposal Will Not Displace Transfer Pricing," *Tax Notes* 126 (March 1, 2010), p. 1028 (quoting Manal Corwin, who said that "[t]here are also transfers that involve a shift of profits associated with risk, which is an economic concept that's well supported and consistent with transfer pricing principles – but risk is a very mobile thing").

[510] *Ibid.* (summarizing the comments of official as follows: "the Administration took the view that it should approach the shifting of risk that carries significant profits in the same way the U.S. antideferral rules focus on having current taxation on passive or mobile income").

However, some may criticize the proposal's distinction between normal and excessive returns because it is not clear that the distinction is based on a measurement of the profits associated with assigned risk. As a result, active business profits derived by a CFC from a transaction that is appropriately priced under the arm's-length standard could be taxed currently in the United States.

Potential incentive to repatriate foreign earnings

Once the CFC's earnings have been taxed as an excessive return under subpart F, there is no tax incentive to retain those earnings outside of the United States. Thus, the proposal may have the effect of encouraging repatriation of some previously-taxed foreign income.

On the other hand, a taxpayer in a low-tax jurisdiction, which would otherwise be subject to the proposed subpart F inclusion, may find it beneficial to expand its activities in the low-tax jurisdiction, rather than repatriate income or increase royalty payments. Some taxpayers both hold intangible property and manufacture products within the same low-tax CFC. If such a taxpayer were subject to a subpart F inclusion for excess income based on its current operations, expansion of its manufacturing (or other high-cost operations) in the low-tax CFC could bring the taxpayer's connected income below the cost-plus-markup threshold. Such an expansion of manufacturing operations could come from moving operations from other foreign jurisdictions or from the United States to the low-tax CFC. The taxpayer could take such steps to expand its cost base and avoid this new category of subpart F income without making significant changes to its operations.

The proposal establishes a separate foreign tax credit limitation category for an excessive return taxed currently; however, the proposal does not otherwise modify the foreign tax credit rules. Thus, a foreign tax credit is provided with respect to any source country taxes paid by the transferee. It is not clear whether the proposal contemplates one excessive return basket, or a separate excessive return basket for each CFC. However, cross-crediting[511] opportunities with respect to excessive return income may be effectively limited by the one-basket approach because this income is, by definition, low-tax. In addition, subpart F income from an excessive return is not included in any limitation basket income when repatriated, including general basket income, because it is previously taxed income. Consequently, the proposal may also diminish cross-crediting opportunities for higher-taxed income in the general limitation basket on future distributions.

The proposal may lead some taxpayers to choose to receive royalty income (currently taxable when received in the United States) rather than income subject to current inclusion under subpart F as an excessive return. Royalty payments are generally a deductible expense in the country from which they are paid. Therefore, royalty payments increase the measured costs associated with the connected transactions, reducing the likelihood that the taxpayer would be subject to the proposed subpart F inclusion. Although additional royalty payments to the United

[511] Cross-crediting refers to the repatriation of highly taxed foreign earnings and using credits generated by this highly taxed income to offset U.S. tax on other lightly taxed foreign income in the same foreign the same type of foreign tax credit limitation basket.

States, like subpart F income from an excessive return, are taxed currently, the U.S. tax consequences may not be equal. This is because cross-crediting for royalty income is not affected by the proposal, as royalty income is not included in the excessive return basket for foreign tax credit purposes.[512] Instead, such income may be included in the general basket where it could be offset by cross-crediting with higher-taxed income. Moreover, a number of U.S. tax treaties reduce or eliminate withholding taxes on royalties. Therefore, any additional tax liability that results from increased royalty income to the United States is likely to be less than the additional tax liability that results from recognizing subpart F income on an excess return. However, the taxpayer must substantiate any increased royalty payment under the arm's-length standard, possibly by reducing the risks and functions undertaken by the CFC.

The net tax consequences to a taxpayer that increases royalty payments to other (non-U.S.) jurisdictions would depend on many factors, but taxpayers can be expected to structure their royalty payments to minimize or eliminate withholding tax on royalty payments from the CFC, minimize or eliminate income tax to the recipient of the royalty, and avoid inclusion in U.S. income (based on the look-through rule of section 956(c)(6)) under subpart F.

Basic framework

The proposal provides the basic framework for identifying subpart F income from excess returns associated with transfers of intangibles offshore. The proposal articulates three elements, each of which needs to be further defined, to determine if the CFC has income that is subject to tax currently: (1) a low foreign effective tax rate; (2) a covered intangible (i.e., an intangible transferred by a U.S. person (directly or indirectly) from the United States to a related CFC); and (3) excess income from transactions connected with or benefiting from a covered intangible. Where each of the elements is present, the taxpayer is subject to tax currently on subpart F income from the excess return.

Low foreign effective tax rate

The proposal does not state the threshold at which an effective tax rate is considered low. There are two principal considerations with respect to determining this threshold. The first is identifying the basis on which to select the threshold rate. The second is the method for calculating that rate.

Selecting the threshold rate.—Selecting the threshold tax rate at which to trigger application of the provision appears aimed at requiring that earnings be subject to some minimum level of tax in the year earned. The proposal does not state whether the tax rate is designed to be a cliff, such that excess income taxed at or below the threshold rate would be subpart F income, and excess income above the threshold would not be subpart F income, or instead is intended to be a sliding scale. Treasury officials have indicated that, for estimating

[512] As described in more detail in Part V.C.2 (Determine the Foreign Tax Credit on a Pooling Basis) in this document, the foreign tax credit pooling proposal would not eliminate all opportunities to cross-credit high-tax income against low-tax royalties.

purposes, a sliding scale of between five percent and 15 percent was used.[513] Under the sliding scale, 100 percent of the excess income would be subpart F income if the tax rate was below five percent, and none of the income would be treated as subpart F if the tax rate were above 15 percent.

Some countries with participation exemption regimes (i.e., territorial tax systems) do not exempt certain foreign earnings that have not already been subject to some minimum level of tax.[514] Other countries with participation exemption regimes have controlled foreign company rules that apply where income is earned in a low- or no-tax jurisdiction.[515] These features of such systems address the broader question of when it is appropriate to provide an exemption for income earned abroad. The basic premise for providing either a foreign tax credit in a worldwide system, or an exemption in a territorial system, is that these mechanisms provide relief against double taxation of the foreign-earned income. Where the foreign-earned income is not subject to taxation, or is subject to very low taxation in the local jurisdiction, it may not be appropriate to allow a full exemption for such low- or no-tax income. In selecting the rate at which to establish a threshold to determine the taxation of excess returns, analyzing participation exemption regimes which include a minimum level of taxation feature could provide informative examples in designing and applying such a threshold.

Taxpayers may adjust investment decisions in response to whatever threshold is selected. For example, taxpayers may be willing to accept a somewhat higher foreign statutory tax rate if doing so provides insurance against unintentionally falling below the effective foreign tax rate threshold and triggering subpart F income at a higher U.S. tax rate. Over time, this potential for avoiding the provision could cause taxpayers to migrate operations to countries with somewhat higher statutory tax rates. If the objective of the proposal is to ensure that a specified minimum threshold of tax is paid on certain foreign income, this migration would effectuate that objective. On the other hand, if the objective is to forestall transfers of U.S. intangibles to CFCs, the proposal may not accomplish that objective if taxpayers are still able to achieve an overall tax rate that is lower than the U.S. rate by migrating excess income into jurisdictions that impose the minimum rate necessary to avoid current U.S. taxation. The use of a sliding scale, however,

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[513] Molly Moses, "Revised Proposal on Excess Returns Applies to Past Intangibles Transfer, Officials Say," *BNA Daily Tax Report* (February 25, 2011).

[514] For example, in order for the participation exemption to apply, Belgium generally requires a minimum 15-percent tax for non-European Union holdings, France requires effective taxation of at least 50 percent of its 33.33 percent tax rate, Singapore requires a 15-percent "headline" tax rate (the highest statutory marginal corporate rate), and Spain requires a tax comparable to the Spanish corporate income tax rate of 30 percent for holdings in non-treaty countries. For more information on tax regimes in several countries, see Joint Committee on Taxation, *Background and Selected Issues Realted to the U.S. International Tax System and Systems that Exempt Foreign Business Income*, (JCX-33-11), May 20, 2011.

[515] For example, the United Kingdom imposes taxation on controlled foreign company profits if the tax on such profits is less than three quarters of the corresponding United Kingdom taxation that would apply if the company were resident in the United Kingdom. The United Kingdom has plans to liberalize its controlled foreign company rules that would exempt intra-group activities with limited United Kingdom connection where there is no tax avoidance motive.

mitigates somewhat against manipulation of the foreign effective tax rate to avoid inclusion under the proposal.

Method of calculating the CFC's effective foreign tax rate.—By basing a subpart F inclusion on a low effective foreign tax rate, rather than a low statutory tax rate, the proposal focuses on the CFC's actual tax liability in the foreign jurisdiction. Current U.S. tax is potentially imposed under the proposal where the CFC has little or no tax liability in the jurisdiction in which the income is earned. While basing the threshold on the effective foreign tax rate imposes a greater administrative burden on taxpayers and the IRS, statutory foreign tax rates can be unreliable indicators as a result of many factors including generous expensing rules, income tax credits, or negotiated tax grants or tax rulings. A taxpayer with a CFC that negotiates or is otherwise entitled to a preferential tax regime may enjoy an effective tax rate that is potentially well below the statutory tax rate in such jurisdiction.

As the proposal intends to use an effective tax rate standard, there are three primary design features to consider: (1) over what period of time to calculate the effective tax rate; (2) whether to use U.S. or foreign tax principles to calculate the effective foreign tax rate; and (3) the treatment of transfers to disregarded entities and actual branches.

Time period of the calculation

A taxpayer may have a low effective tax rate in any particular year for a variety of reasons. For example, the taxpayer may have incurred losses in a prior year that the taxpayer is carrying forward to offset current earnings. Similarly, if the effective foreign tax rate is determined under U.S. tax principles (discussed below), timing differences (e.g., temporary timing differences resulting from disparate depreciation allowances) may cause variations that may not be present if the effective foreign tax rate is determined under foreign tax principles. While over time such differences reverse, in some circumstances the taxpayer may have already borne the burden of current U.S. taxation resulting from an excessive return. If the proposal's policy rationale is to discourage the transfer of intangible property to low-tax jurisdictions, consideration should be given to whether a one-year, or a multi-year, measure of an effective tax rate more accurately identifies low-tax jurisdictions.

U.S. or foreign tax principles

The proposal could determine the effective foreign tax rate based on either U.S. or foreign tax principles. Both approaches are reflected in current subpart F rules. For example, the high-tax exception from foreign base company sales income[516] determines the effective tax rate imposed on income based on the taxes deemed paid under section 960,[517] a U.S. tax principle. In contrast, the sales and manufacturing branch rules apply a tax rate disparity test to determine if the use of a branch in a different country for such activities has substantially the

[516] Sec. 954(b)(4).

[517] Treas. Reg. sec. 1.954-1(d)(3)(i).

same effect as if it were a subsidiary of the CFC.[518] The tax rate disparity test is based on foreign law principles.[519]

Arguably, the policy behind the proposal is closer to that of the high-tax exception than to that of the tax rate disparity test. Under the tax rate disparity test, the goal is to determine whether there is an undue advantage in using a branch to segregate certain activities into separate (non-U.S.) countries. Thus, the tax rate disparity test is intended to identify the difference that actually results under local tax, thereby making it logical to apply foreign law concepts. On the other hand, the high-tax exception from foreign base company income permits taxpayers to avoid a subpart F inclusion in circumstances in which the foreign jurisdiction's tax rate was not a motivation for deriving income through the CFC. This is similar to the underlying objective of the proposal, which is targeting transfers of intangible property to low-tax jurisdictions. Specifically, under the proposal, there is no evidence of excessive income shifting if the intangible property is transferred to a relatively high-tax jurisdiction. This similarity suggests that U.S. tax principles should be applied when determining the effective foreign tax rate of the CFC.

Moreover, if the CFC's effective foreign tax rate is determined based on foreign principles, the IRS would be required to audit effective foreign tax rate calculations based on unfamiliar rules. This imposes additional burdens on the IRS, which it has intentionally avoided in the past.[520]

However, taxpayers can be expected to selectively structure their transactions to take advantage of differences between the foreign tax base (on which the CFC's actual tax liability is determined) and the U.S. tax base. Such strategies likely will be designed to decrease the U.S. tax base in comparison to the foreign tax base, such that the effective foreign tax rate is higher than it otherwise would be.

Transfers to disregarded entities and actual branches

The third consideration is how to measure the effective foreign tax rate with respect to transfers to either: (1) an eligible entity that has "checked-the-box" and elected to be disregarded as separate from its owner (a so-called "disregarded entity"); (2) an actual foreign branch; or (3) a CFC with pass-through investments. If either a disregarded entity or an actual foreign branch is respected, then the transfer may be treated as a transfer to the CFC. When determining the effective foreign tax rate of the CFC owner, the calculation is made based on the blended effective foreign tax rate incorporating the income and taxes of the actual CFC plus any pass-through investments, such as: (1) the disregarded entity or the actual foreign branch; (2) any

[518] Treas. Reg. sec. 1.954-3(b)(1).

[519] Treas. Reg. sec. 1.954-3(b)(1)(i)(c)(2)(ii); see also Treas. Reg. sec. 1.954-3(b)(1)(i)(b), -3(b)(1)(ii)(b); see also PLRs 200945036 and 200942034.

[520] The preamble to the regulations which implemented the high-tax exception of section 954(b)(4) states that such a rule would impose a significant burden on the IRS. See 1995-2 C.B. 89, 91.

other disregarded entities or actual branches owned by the CFC and (3) any partnership items attributable to the CFC.

If a taxpayer were to contribute assets to the CFC to increase the CFC's effective foreign tax rate and thereby avoid application of the proposal, the taxpayer would be engaged in a practice referred to as "stuffing." For an example of stuffing, assume that a CFC with a low-tax rate has only one investment, intangible property that it acquired in a covered transfer. The low-tax CFC owns no subsidiaries, nor any other disregarded entities or actual branches. At the beginning of the tax year, the taxpayer determines that the low-tax CFC will have both a low effective tax rate and an excessive return. To avoid a subpart F inclusion for an excessive return, the taxpayer contributes a group of wholly-owned CFCs, each of which is a relatively high-tax CFC, to the low-tax CFC in exchange for shares; each of the high-tax CFCs then elect to be disregarded as separate from their owner (the low-tax CFC). The transactions qualify for nonrecognition treatment for U.S. tax purposes. Without an "antistuffing" rule, the annual tax liability of high-tax CFCs would be combined with any tax paid by the low-tax CFC when computing the effective tax rate of the low-tax CFC. If the blended effective tax rate exceeds the threshold, then there is no possibility of an income inclusion for an excessive return under subpart F. Arguably, this is not consistent with the intent of the proposal.

In contrast, if a disregarded entity or actual foreign branch is treated as a separate corporation, then a covered transfer to that disregarded entity or actual foreign branch may be treated as a covered transfer to a CFC. When determining the effective foreign tax rate of the transferee on a stand-alone basis, the local tax implications of the covered transfer could be isolated and more precisely determined.[521] This approach prevents taxpayers from selectively avoiding the application of the proposal by blending high-tax and low-tax operations within a CFC so as to exceed the threshold effective foreign tax rate.

Covered intangible

The proposal applies to certain excess income from transactions connected with or benefitting from a covered intangible. For purposes of the proposal, a "covered intangible" is an

[521] There is precedent in the Code and the regulations for treating a branch as a separate corporation for specific purposes. These rules date back to 1962, and were intended to prevent a CFC from using a foreign branch to avoid foreign base company sales income under subpart F. See, e.g., sec. 954(d)(2) and Treas. Reg. sec. 1.954-3(b). However, Treasury and the IRS efforts to impose "branch rule" treatment on income (including royalties) under the foreign personal holding company provisions were the subject of vigorous challenge. The Internal Revenue Service Restructuring and Reform Act of 1998 included a provision that would have imposed a moratorium on the implementation of regulations proposed in conjunction with the issuance of Notice 98-11 (1998-1 C.B. 433) until considered by the Congress. See, e.g., S. Rep. No. 105-174, reprinted in 1998-3 C.B. 537, 645- 650. Ultimately, Treasury and the IRS withdrew the temporary regulations and announced their intention to issue a notice of proposed rulemaking covering hybrid transactions. IRS Notice 98-35, 1998-2 C.B. 34. Accordingly, the moratorium was not enacted. Notably, unlike the foreign base company sales income rules of section 954(d), the foreign personal holding company provisions of 954(c) do not contemplate such a branch rule. In addition to the sales and manufacturing branch rules of subpart F, the subpart J rules regarding foreign currency transactions are applied to qualified business units, meaning any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books or records. Sec. 989(a).

intangible transferred from the United States directly or indirectly by a U.S. person to a related CFC.

Unlike a similar proposal in Administration's Fiscal Year 2011 Revenue Proposals (the "prior year proposal"), the proposal specifies the types of activities that constitute a transfer for purposes of computing subpart F income under the proposal. The proposal specifies that transfers of intangibles by sale, lease, license, or through any shared risk or development agreement (including any cost sharing arrangement) are considered transfers for purposes of the proposal.

The proposal does not require that the intangible property be originally developed in the United States, only that it is transferred from the United States. Additionally, the proposal includes both direct and indirect transfers. The proposal does not specify what constitutes an indirect transfer. The transfer language of the proposal could be interpreted very broadly and does not create a bright-line test. For example, the provision of services using embedded intangible property[522] is not specifically listed in the proposal, but it could be an indirect transfer for purposes of determining subpart F under the proposal.

The proposal does not include the output that results from contract research performed in the United States at the expense of a foreign affiliate as a covered intangible. Thus if a CFC acquires intangible property from an unrelated third party or engages a U.S. affiliate to perform contract research and development services, the proposal does not apply.

Application to transactions connected with or benefiting from pre-effective date transfers

The prior year proposal applied to transfers occurring in tax years beginning after December 31, 2010. In contrast, this proposal does not rely on the date of the transfer of the intangible property; rather it relies on the date of transactions that are connected with or benefit from a covered intangible, and applies to the transactions if the occur after December 31, 2011.

In many instances, intangible property is made available to a CFC pursuant to an agreement covering multiple years. For example, a CFC that is required to build facilities and develop supporting plant, property and equipment to make and sell a patented product may have a long-term license with the owner of the patent. Similarly, where the intangible property is made available pursuant to an outright transfer of rights or a buy-in agreement, the useful life of the intangible property likely extends beyond the initial year in which it was transferred. Under the proposal, transactions connected with or benefiting from a transfer made prior to the effective

[522] Under the temporary cost sharing regulations, compensable "platform contributions" includes services that are provided within the cost-sharing arrangement. Temp. Treas. Reg. secs. 1.482-7T(c)(1), (c)(3), (c)(5) *Example* (2), and 1.482-7T(k)(2)(ii)(H). Thus, it is not necessary that there be an explicit transfer of intangible property. It may be appropriate for legislation to address similar migrations of value in which there are no explicit or identifiable transfers of intangible property. Cf., *Hospital Corp. of America v. Commissioner*, 81 T.C. 520 (1983) (presenting an affiliate with the opportunity to negotiate and perform a contract is not the same as transferring a legally enforceable right under sections 351 and 367; however, the affiliate had been provided compensable services, and the court imposed a section 482 services adjustment).

date may give rise to subpart F income if they result in transactions after the effective date that give rise to excess income subject to a low foreign effective tax rate.

Some may argue that this provision has a retroactive effect related to such intangible transfers and connected transactions. Under present law, absent another applicable subpart F provision, the connected transactions do not generate subpart F income. Thus, this provision may be viewed as unfairly changing the rules of taxation for earnings that are properly allocable to the CFC where a toll-charge was previously paid upon the original outbound transfer or where an arm's length royalty is paid (including circumstances in which an advanced pricing agreement was previously in place or where the buy-in or royalty amount was previously settled with the IRS). On the other hand, this provision does not change the transfer pricing rules or otherwise effect the allocation of income between the U.S. transferor and the related CFC; rather, the provision effects only the ability to defer the CFC earnings in situations that some may view as aggressive income shifting to low-tax jurisdictions.

Limited to intangible property that is transferred from the United States

The proposal applies only to intangible property that is transferred directly or indirectly from the United States. As a result, taxpayers may perform more research and development activities outside the United States at their CFCs from inception to avoid its application. In addition, CFCs may hire related U.S. affiliates to perform contract research and development services on their behalf more frequently.

Intangible property developed by a CFC.–Income from intangible property developed by a CFC is outside the scope of the proposal. Accordingly, CFC income derived from intangible property developed and owned by a CFC organized in a low-tax jurisdiction is not subject to excessive return testing unless the income is from a transaction connected with or benefitting from a covered intangible (as discussed below).

Within a taxpayer's affiliated group, research and development is often performed in the United States. Research and development services are sometimes provided to a CFC pursuant to a research and development service agreement or a cost-sharing arrangement. The CFC compensates the taxpayer for services performed at an arm's-length mark-up (typically within the range of five percent to 10 percent).[523] Thus, the taxpayer commits its U.S.-based intellectual capital resources to the research and development effort, but the CFC takes the financial risk on the research and development project, and therefore is entitled to ownership (as well as any above-normal returns) if the research and development efforts are successful. If, instead, these services are provided in the context of a cost-sharing arrangement, the only benefit to the taxpayer from the commitment of its research and development resources is the right to exploit the new intangible property consistent with the rights assigned to the taxpayer in the cost-sharing

[523] See, e.g., *Westreco v. Commissioner*, T.C. Memo 1992-561 (fees, provided in a contract research agreement between related parties, in the amount of 7.5 percent on the first $350,000 of costs, five percent with respect to the next $1,150,000 of costs, and 3.5 percent on costs over this amount, were comparable to fees between uncontrolled corporations). However, an arm's-length result for any particular contract research and development agreement would depend on the specific terms of that contract research and development arrangement.

arrangement (e.g., the taxpayer is assigned the right to exploit the U.S. market). In addition, the taxpayer may be entitled to claim the research credit provided by section 41 under such research and development arrangement. In exchange, the taxpayer shares in the development cost pro rata, based on the reasonably anticipated benefits of each cost-sharing participant (e.g., the taxpayer's share is based on the expected U.S. sales as a percentage of expected total sales). In either case, under present rules there is no transfer of intangible property to the CFC under the research-and-development-services agreement or cost-sharing arrangement because the CFC owns the output that results from the contract research and development services from inception. However, under the proposal, the cost sharing arrangement may be considered a transfer of intangible property and the excess income may be includible as subpart F income. As a result, some may argue that this proposal could discourage the location of research and development activities in the United States.

However, there are other important considerations in selecting the physical location for research and development, as well as selecting the legal entity that funds and bears the risk of research and development. For example, access to, and retention of, qualified scientists may be important reasons to locate research and development activities in the United States. In addition, any loss that results from research and development performed in a low-tax jurisdiction that is not successful is worth less than a loss incurred in a high tax jurisdiction (assuming that losses are deductible). Therefore, taxpayers are generally selective when identifying projects for foreign development, choosing only those projects with the highest likelihood for success. Nonetheless, taxpayers may increase foreign research and development activities by CFCs to avoid current taxation under the proposal.

Intangible property acquired outside the United States.–Under current U.S. tax rules, there are several reasons why taxpayers acquiring intangible property, directly or indirectly, may consider making the acquisition through a CFC.[524] First, the 35-percent U.S. tax rate imposes a relatively high cost on income earned from intangible property in comparison to the tax liability that would be incurred if the same income were earned in another jurisdiction, most of which now have lower statutory tax rates on business income.[525] Second, the United States imposes tax on any built-in gain when intangible property is transferred outside the United States, which makes even temporary ownership of newly acquired intangible property a potentially costly decision.[526] Third, the lock-out effect of deferral[527] means that companies may have funds

[524] If a direct acquisition includes the right to use certain intangible property in the United States, the CFC may be treated as holding an investment in U.S. property for purposes of section 956.

[525] For the corporate income tax rates of OECD member countries, see the OECD Tax Database, Table II.1, available at http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#cci.

[526] For example, assume on January 1 that a U.S. company acquires the rights to a molecule in an early stage of development that has promise as a potential cure for chicken pox. The molecule is purchased for $100, its fair market value on that date. On February 1, the company discovers that the drug stimulates hair growth. On March 1, the company transfers the rights to the molecule to newly formed CFC organized in the country that does not impose a tax on business income. The U.S. company is subject to U.S. tax based on the built-in gain (the fair market value of a molecule that potentially cures baldness less it basis of $100) under section 367(d). On January 1, the rights to the molecule were worth $100, but the fair market value (and corresponding built-in gain for U.S. tax purposes) on February 1 is presumably much higher due to the discovery of the molecule's hair-growing potential.

available offshore to invest in such acquisitions. Indeed, foreign acquisitions are often an important use of CFC cash. The proposal adds another consideration to this list, and favors acquiring certain intangible property through a CFC.

Excess income from transactions connected with or benefitting from a covered intangible

The proposal requires current taxation of excess income from transactions connected with or benefitting from a covered intangible. This requires determining the connection between the income and the covered intangible, and computing the amount of excess income.

Excess income

Intangible property may be transferred outside the United States in order to make it available to a foreign manufacturer that makes and sells the goods that are produced based on the intangible property. Taxpayers employ various approaches for transferring intangible property.[528] In some cases, intangible property is transferred to a jurisdiction that does not impose any tax; typically, taxpayers do not make substantial investments in plant, property and equipment in such jurisdictions. In these situations, a low effective tax rate threshold may be a sufficient basis for targeting income shifting.

In other cases, intangible property is transferred to a jurisdiction that either imposes a relatively low tax on business income or in which taxpayers are able to negotiate favorable tax rulings that reduce or substantially eliminate local tax. Taxpayers may invest in plant, property and equipment and establish operations that generate high profit margins in these low-tax countries; however, there is no universal formula that prescribes how any given taxpayer will structure its legal form, capitalize its structure with cash and assets, or operate its business in such countries. A low effective tax rate threshold may not be a sufficient basis for targeting income shifting because it does not distinguish between taxpayers that make substantial investments in local operations and those that have minimal presence.

The excessive return threshold could be viewed as making this distinction. This proposal differs from the prior year proposal in that it specifies that the excess income is computed based on the costs associated with certain transactions connected with the transferred intangible. The

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[527] Once income has been earned offshore in a lower tax jurisdiction, it can be more profitable to reinvest offshore rather than repatriate the after-(foreign)-tax earnings. This is referred to as the "lock-out effect." This arises because after-tax returns on a foreign investment are generally higher than the after-tax returns the taxpayer can obtain on a similar investment after the funds are repatriated to the United States because the repatriated funds will be subject to residual taxation by the United States before they can be invested domestically. See Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCS-55-08), June 25, 2008; and John Graham, Michelle Hanlon and Terry Shelvin, "Barriers to Mobility: The Lockout Effect of US Taxation of Worldwide Corporate Profits," 63 *National Tax Journal* (December 2010), pp. 1111-1144, available at http://cber.utk.edu/confpapers/Gra_Han_She.pdf.

[528] See generally Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

proposal further specifies that the excess intangible income would be computed on a cost-plus-markup basis. Costs would include all expenses properly allocated and apportioned to gross income from transactions connected with or benefitting from a covered intangible. A percentage markup is computed under the proposal, and any remaining income from such transactions is included as subpart F income. The proposal does not specify the markup percentage, but for purposes of estimating the proposal, Treasury assumed a 50 percent return on operating costs.[529]

The use of operating costs rather than a balance sheet approach to determining excess income addresses many of the concerns regarding the computation of excessive returns under the prior year proposal.

Transaction connected with or benefitting from a covered intangible

Another significant difference between the proposal and the prior year proposal is the current proposal's connection between the transferred intangible and the excess return. The proposal specifies that the excess intangible income is income from transactions connected with or benefitting from the covered intangible. This approach has the advantage of more closely linking the proposal to its stated purpose, but could be complicated to administer to the extent a CFC's business extends across multiple product lines and activities, and includes shared resources.

The language in the proposal is broad and clearly includes direct connections such as the sale of patented products where the U.S. parent sells or licenses the rights to make and or sell the patented products to the CFC. It is less clear to what extent a transaction might be deemed under the proposal to "benefit from" the covered intangible.

Cost sharing arrangements.−Transfers made in conjunction with cost-sharing arrangements present a unique issue. With cost sharing, an important "use" of the transferred intangible property may be as the platform from which the next generation is developed. For example, with respect to the transfer of version 1.0 intangible property, the buy-in agreement might entitle the CFC to (1) the foreign "make and sell" rights during the useful life of version 1.0, (2) the right to develop version 2.0 from version 1.0, and (3) economic ownership of the foreign rights to version 2.0. To the extent that the CFC avails itself of the intangible property by making and selling version 1.0 products, gross income from transactions involving the use of version 1.0 in production subjects the income from such transactions to testing under the proposal. On the other hand, upon the successful development of version 2.0, it is unclear whether production of version 2.0 products should be considered as benefitting from the transfer of version 1.0, and therefore subject to testing under the proposal. While the nexus between version 1.0 and version 2.0 may be sufficient to warrant this approach, it is unclear whether it should also continue in perpetuity as subsequent versions (3.0, and so forth) are developed.

Arguably, a covered intangible that the proposal treats as continuing in perpetuity during the useful life of any version 1.0 progeny, without regard to the actual useful life or usefulness of

[529] Molly Moses, "Revised Proposal on Excess Returns Applies to Past Intangibles Transfer, Officials Say," *BNA Daily Tax Report* (February 25, 2011).

version 1.0, mitigates the financial incentive to cost share intangible property development. On the other hand, if the proposal does not specify how to treat subsequently developed versions, determining, on a case-by-case basis, whether a subsequently developed version has sufficient nexus to the original covered intangible may impose significant administrative burdens on both taxpayers and the IRS.

Treaty considerations

The proposal requires certain active business income earned by a CFC to be taxed currently in the United States to the United States shareholder. To the extent that the CFC is organized in a jurisdiction with which the United States has a tax treaty, some treaty partners may argue that the proposal is inconsistent with the obligations established by the treaty.

Source and residency taxation

While treaties generally allocate the primary right to tax business profits to the source country, this general rule does not preclude concurrent (but residual) taxation (i.e., the imposition of residual U.S. tax in excess of the statutory tax rate in the country of exploitation for the year that the income is earned) by the residence country provided that a foreign tax credit is available to avoid double taxation. The contemporaneous expansion – both within and outside of the United States – of residence taxation of specific types of undistributed earnings is consistent with the widespread acceptance by U.S. treaty partners of concurrent (but residual) taxation of subpart F type income; these provisions are not viewed by treaty partners as repudiating the intent or the terms of tax treaties. The OECD concurs with this view.[530]

Concurrent (but residual) taxation by the United States has been limited to situations predominantly involving income from: (1) insurance or reinsurance of U.S. risks; (2) passive income; (3) "the purchase and sale of property without any appreciable value being added to the product by the selling corporation;"[531] and (4) the performance of certain services outside the CFC's country of incorporation (the latter two of which are referred to as the "base company" rules). Arguably, the first two types of income are each passive in nature, while base company services income is active because value is generated by the bona fide performance of services. Base company sales income may be active, if value is being added to the property that is purchased. In this way, taxing active income currently under the proposal is within the established framework of concurrent (but residual) U.S. taxation because, as with the proposal,

[530] OECD, Commentaries on the Articles of the Model Tax Convention (2008), Article 1, par. 23. ("Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognized as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities").

[531] H.R. Rep. No. 87-1447 (1962), p. 62, reprinted in 1962-3 C.B. 405. See also S. Rep. 87-1881 (1967), p. 84, reprinted in 1962-3 C.B. 707. The Conference Report refers to foreign base company sales income as arising when the property sold was neither manufactured in, nor sold for use, consumption or disposition in, the country in which the controlled foreign corporation is organized. H.R. Conf. Rep. No. 87-2508 (1962), p. 30, reprinted in 1962-3 C.B. 1129.

in some circumstances active income is subject to concurrent (but residual) U.S. taxation under present law.

On the other hand, residual active services income is concurrently taxed by the United States when it is presumed, based on the fact that the services are performed outside the country in which the CFC is organized, as being derived from a largely artificial arrangement. A similar construct applies to base company sales income, but the applicable provisions turn on whether activities have been shifted outside the country in which the CFC is organized to achieve a lower tax rate on selling activities.[532] Under the proposal, concurrent (but residual) U.S. taxation may apply to active income even where the CFC makes bona fide, substantive, contributions to the production of active business profits in the same country in which it is organized. Accordingly, some treaty partners may be concerned that the proposal conflicts with negotiated treaty rights to the extent that it is viewed as the residence jurisdiction "taking away [the source jurisdiction's] right to effectively grant tax holidays to foreign investors"[533] or attract investment through low tax rates. However, the U.S. has never sanctioned tax sparing agreements in treaties (i.e., provisions that preserve tax incentives granted by lower-income jurisdictions to induce foreign direct investment by limiting residual taxation of earnings upon repatriation to a higher-income jurisdiction) and tax sparing agreements have been an impediment to concluding treaty negotiations.

Tax administration

Implicit in the proposal may be the expectation that, despite some increase in taxpayer burden necessary to accurately report subpart F income from an excess return, current taxation of an excessive return will reduce transfers of intangible property from the United States, resulting in a net decrease in the aggregate administrative burden. The proposal may require taxpayers to adopt new record keeping practices to identify and track each transfer of intangible property from the United States that could potentially result in a subpart F inclusion for an excess return. In many instances, such transfers are documented in contracts, as the contracts help ensure the deductibility of royalties or other forms of compensation paid for the use of intangible property and also support profit allocations for transfer pricing purposes. However, as a practical matter, the level and detail of documentation varies by taxpayer. In addition, if the intangible property covered by the proposal is defined broadly, there may be some intangible property transferred to CFCs without documentation.

The proposal presents administrative challenges to the IRS as well, as the IRS is required to examine taxpayer self-assessment of subpart F income from excess returns. The proposal relies on subpart F as the principle mechanism for addressing the issue of excessive income shifting, rather than relying on transfer pricing adjustments under section 482. The proposal operates mechanically as an antiabuse provision, by positing that, as a policy matter (based on administrative experience and studies), excessive income shifting is typically accompanied by

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[532] H.R. Rep. No. 87-1447 (1962), p. 62; see also S. Rep. 87-1881 (1967), p. 84.

[533] Reuven S. Avi-Yonah, "International Tax as International Law," 57 *Tax Law Review* (2004), pp. 483, 489.

the presence of: (1) a low effective foreign tax rate; (2) a relatively high ratio of income to costs; and (3) intangible property transfers from the United States. As a result, taxpayers cannot avoid an income inclusion under subpart F by proving that there is no actual excessive income shifting, nor any intent to shift excessive income. The effect is to treat dissimilar taxpayers the same, such that some taxpayers with legitimately high rates of return are taxed currently as if they had engaged in excessive income shifting.

However, the difficulties that the IRS currently faces due to information asymmetry (i.e., the fact that the taxpayer inherently has more complete knowledge of its own facts than does the IRS) may increase under the proposal. The difficulties of identifying intangibles, determining pricing methodologies, and measuring income attributable to an intangible continue to be present in transfer-pricing controversies and are introduced into subpart F examinations. While the proposal can be structured with observable, objective criteria for determining the effective foreign tax rate and determining the excess income, taxpayers control information regarding transfers of intangible property and the relationship between the intangible property and the transactions that generate income to the CFC.

Opponents contend that providing taxpayers with the opportunity to establish that their circumstances do not evidence excessive income shifting (i.e., that the taxpayer is in compliance with the arm's-length standard) is necessary to ensure a more equitable approach since the proposal does not distinguish among industries or take into account the diverse cost structure or rates of return different industries typically earn. Without such opportunity, industries with traditionally high rates of return could find that the industry, as a whole, is disproportionately subject to the proposal's current taxation on excess income when compared to other industries.

Prior Action

A similar proposal was included in the Administration's Fiscal Year 2011 Revenue Proposals.

4. Limit shifting of income through intangible property transfers

Present Law

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits or allowances among related business entities[534] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate. The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length.

[534] The term "related" as used herein refers to relationships described in section 482, which applies to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

Sections 367 and 482 and the commensurate with income principle

In 1986, Congress added at the end of section 482 the following sentence: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[535] In the same year, Congress added a comparable rule for transfers of intangible property in a transaction otherwise nonrecognized for tax purposes.[536] By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[537]

In identifying the property that is within the scope of the commensurate with income standard, Congress adopted the definition of intangible property used in determining the possession credit under section 936.[538] The definition enumerates specific types of property that are within the meaning of the statute, including any (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item which has substantial value independent of the services of any individual.[539] The scope of property that may qualify as a "similar item" is not further defined in the statute.

The legislative history accompanying the enactment of the commensurate with income principle states that transfer pricing problems are "particularly acute" in the case of high-profit-potential intangibles.[540] The House Committee on Ways and Means Report on the Tax Reform Act of 1985 (the "Committee Report") identified, as a recurrent problem, the absence of comparable arm's-length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's-length concept in the absence of real comparables.[541] The Committee Report concluded that because of the "extreme difficulties" in determining whether arm's-length transfers between unrelated parties are comparable, it was appropriate to require

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[535] Sec. 1231(e)(1), The Tax Reform Act of 1986, Pub. L. No. 99-514 ("1986 Tax Reform Act").

[536] Sec. 367(d)(2); Sec. 1231(e)(2), 1986 Tax Reform Act.

[537] H. R. Rep. No. 99-426, p. 423.

[538] In 1996, section 936 was amended to add subsection (j), which provides that the credit terminates, subject to a 10-year transitional period for existing credit claimants.

[539] Sec. 936(h)(3)(B), incorporated by reference in sections 482 and 367(d). Treas. Reg. sec. 1.482-2A(d)(3)(i).

[540] H. R. Rep. No. 99-426, p. 424.

[541] *Ibid.*, pp. 423-424.

payments made on a transfer of an intangible to a foreign affiliate to be commensurate with the income attributable to the intangible.[542]

The commensurate with income principle addressed these problems by shifting the focus of transfer pricing analysis to the income actually derived from exploitation of the transferred intangible and away from the identification of questionably comparable third-party transactions. In particular, Congress intended that compensation for intangibles take into account actual profit experience and that pricing adjustments reflect major variations in the annual amounts of revenue.[543] In a study mandated by The Conference Report for the 1986 Act and commonly referred to as the White Paper,[544] Treasury and the IRS characterize the commensurate-with-income principle as a clarification that prior law is consistent with the arm's-length standard.[545] An important consequence of this conclusion, reflected in subsequently issued Treasury regulations, is that comparable third-party transactions would continue to play a role in determining appropriate transfer prices.[546]

Methods of transferring intangible property to foreign affiliates

A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways. The mechanism used to transfer intangible property to a foreign affiliate frequently dictates whether section 482 or section 367(d) determines the tax treatment of the consideration received by the U.S. person. The first is through an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction (for example, a capital contribution of the intangible property to the affiliate in an exchange that meets the requirements of section 351, or an exchange made pursuant to a plan of reorganization that is described in section 361). The second is through a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate.[547] The third is the provision of a service using the intangible

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[542] *Ibid*., p. 425.

[543] Because actual profits could be used as the basis for re-determining the transfer price retroactively, some commentators contend that the principle conflicts with the arm's-length standard. See, e.g., Marc M. Levy and Stanley C. Ruchelman, "Section 482 − The Super Royalty Provisions Adopt the Commensurate Standard," 41 *Tax Lawyer* 611 (Spring 1988); E.C. Lashbrooke, Jr., "I.R.C. §482 Commensurate with Income Standard for Transfers of Intangibles," 1 *DePaul Bus. L. J.* 173, 186 (1989).

[544] H.R. Conf. Rep. No. 99-841, pt. 2 (hereafter "Conference Report 99-841"), II-638, and IRS Notice 88-123, 1988-2 C.B. 458 (hereafter, the *"White Paper"*).

[545] *Ibid*., p. 472. The *White Paper* bases this conclusion on a statement in Conference Report 99-841 that income from a transferred intangible should be divided based on the relative economic contributions of the parties. The *White Paper* states that this approach is consistent with what unrelated parties do and concludes from this that the general goal of the commensurate with income requirement is "to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."

[546] *Ibid*., p. 473.

[547] The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer's conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

property, rather than a direct transfer of the property. Finally, a U.S. company may transfer intangible property through a qualified cost-sharing arrangement with one or more foreign affiliates, under which the participants make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service.

Generally, a license or a sale of intangible property, or the provision of a service that uses intangible property, is subject to section 482. With respect to cost-sharing arrangements, specified rights to existing intangible property can be transferred to other cost-sharing participants either through a sale or a license. In such cases, the U.S. company receives a payment from the other cost-sharing participants with respect to its contribution to the cost sharing agreement of any resource, capability or rights that provide the platform for the intangible development.[548]

If a transfer of intangible property occurs in connection with certain corporate transactions, section 367(d) applies to override the general nonrecognition rules of sections 351 and 361. As a result, the transferor of intangible property must recognize imputed income as though he had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer. The appropriate amounts of those imputed payments are determined under the section 482 regulations; however, regulations specifically exempt transfers of foreign goodwill or going concern value from the income recognition provisions of section 367(d).[549]

Section 482 regulations for transfers of intangible property

Treasury Regulation section 1.482-4, issued in 1994, sets forth the basic rules for determining income in connection with a transfer of intangible property. The rules specific to intangible transfers are subject to the overarching principles of the arm's length standard and the "best method rule"[550] applicable to all transfers of property, which in turn rest on reliability, comparability and presence or absence of realistic alternatives. In order to meet the arm's length standard, consideration for the transfer of an intangible in a controlled transaction (i.e., a transaction between related parties) must be commensurate with the income attributable to the

[548] Temp. Treas. Reg. secs. 1.482-7T(c)(1) and 1.482-7T(b)(ii). The payment for this contribution eliminates the benefit of expense deductions for research and development ("R&D") previously performed in the United States; amounts received in excess of previously deducted R&D expenses incurred should represent the present value of the intangible property transferred, discounted for the risk assumed by the transferee. The ongoing cost-sharing payments offset any deductions that the recipient of such payment takes for post-buy-in R&D activities. Such ongoing cost-sharing does not, however, include compensation for the return on any products that may result from that R&D.

[549] Temp. Treas. Reg. sec. 1.367(d)-1T(b).

[550] Treas. Reg. 1.482-4(c)(1).

intangible. Under the best method rule, one must use the method that provides the most reliable measure of an arm's length result, under the facts and circumstances.

To evaluate comparability, the regulations require an analysis of all factors that could affect prices or profits in uncontrolled transactions. Each method requires an analysis of all the factors that affect comparability under that method, and a specific comparability factor may be particularly important to a particular method.[551] The comparability factors include: (1) functions; (2) contractual terms; (3) risks; (4) economic conditions; and (5) the property or services transferred.[552] The regulations do not require that a comparable transaction be identical to the related party transaction, but it must be sufficiently similar to the related-party transaction to provide a reasonable starting point for determining the arm's-length price.[553] If there are material differences between the related-party transaction and the comparable transaction, adjustments are be made to the relevant formulas, but only if it is possible to determine the impact of those differences on prices or profits with sufficient accuracy.[554] If it is not possible to determine the impact of those differences on prices or profits with sufficient accuracy, the comparable transaction may be taken into account in establishing the arm's-length price, but it is considered a less-reliable measure of an arm's-length result.

In many cases, risk can be assigned by contract within an affiliated group to entities with the objective ability to bear such risk. However, whether the risks in the related party transaction and in the comparable transaction are, in fact, comparable may be difficult to ascertain. Nonetheless, the respect given to contractual agreements between related companies is derived from the longstanding doctrine of *Moline Properties v. Commissioner*,[555] in which the Supreme Court rejected the taxpayer's attempt to disregard the corporate form.[556] Under the doctrine of corporate entity articulated in *Moline Properties*, the corporation remains a separate taxable entity, provided the purpose of the corporation is the equivalent of a business activity or the carrying on of a business by the corporation.[557]

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[551] Treas. Reg. sec. 1.482-1(d)(1).

[552] *Ibid.*

[553] Treas. Reg. sec. 1.482-1(d)(2).

[554] *Ibid.*

[555] 319 U.S. 436 (1943).

[556] Although *Moline Properties* involved an individual shareholder, this rule applies equally to a corporation and its subsidiaries. *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 433 (1949).

[557] *Moline Properties v. Commissioner*, 319 U.S. 436, 439 (1943), citing *New Colonial Co. v. Helvering*, 292 U.S. 435, 442 and *Deputy v. Pont*, 308 U.S. 488, 494. In contrast, new section 7701(o)(1) provides that a transaction is treated as having economic substance only if (1) the transaction changes "in a meaningful way" (apart from federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a "substantial purpose" (apart from federal income tax effects) for entering into such transaction. For discussion of the choice to utilize a related-affiliate in a transaction, see the text with footnote 349 in Joint Committee on Taxation, *Technical*

The facts and circumstances to consider in selection of the best method necessarily include proper identification of the intangibles, determining whether a transaction should be valued as part of a series of transactions and whether there were realistic alternatives to the transaction as structured by the taxpayer. Property interests that do not fit within the meaning of the first five items on the list of intangible property are sometimes referred to as "unidentified intangible property." To determine whether an intangible interest such as workforce in place, goodwill and going concern value is within the above definition of intangible property, one must determine whether the unidentified intangible property is sufficiently similar to the other items for which compensation commensurate with income must be recognized. Although "workforce in place" is not defined in the transfer pricing regulations, it is addressed in the provisions dealing with amortization of intangibles, under which it is defined as a separate asset that includes "the composition of a workforce (e.g., the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes." [558] Prior to the promulgation of the amortization regulations,[559] the Tax Court held in *Ithaca Industries v. Commissioner*[560] that workforce in place "is not separate and distinct from going concern value" because it is not a wasting asset. Following the Supreme Court decision in *Newark Morning Ledger*,[561] the Court of Appeals affirmed *Ithaca Industries v. Commissioner,* but noted that it was no longer appropriate to deny a deduction on the basis on an intangible asset's resemblance to the classic conception of goodwill or going-concern value. Instead, the decision of the Tax Court was affirmed because the useful life of the workforce in place was not ascertainable.

In instances in which multiple transactions are interrelated, taxpayers may be required to value the transactions in aggregate rather than as discrete transactions. Conversely, distinct methods for each distinct transaction may be appropriate.[562] In determining whether valuation in aggregate or asset-by-asset is the more reliable method, the IRS considers the extent to which the intangibles, both identified and unidentified, are interrelated. For example, the IRS has applied this principle to require that an outbound transfer of a network of contracts be valued in aggregate, rejecting a taxpayer contention that gain under section 367(d) could be determined by

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Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10), March 21, 2010, p. 153.

[558] Treas. Reg. sec. 1.197-2(b)(3).

[559] Section 197 was enacted on August 10, 1993, Pub. L. No. 103-66. Treas. Reg. sec. 1.197-2(b)(3) was issued on January 20, 2008. T.D. 8865, 2000-1 C.B. 589.

[560] *Ithaca Industries v. Commissioner*, 97 T.C. 253, 271-272 (1991), 17 F.3d 684 (4th Cir. 1994), cert. denied, 513 U.S. 821 (1994). See also *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677, 690 (1971) (workforce in place "formed a part of the going-concern value which was purchased").

[561] 507 U.S. 546 (1993).

[562] Treas. Regs. secs. 1.482-4(c)(1) and 1.482-1(f)(2)(i).

looking to separate contracts and assigning any residual value attributed to noncompensable foreign goodwill.[563]

The realistic alternative principle is reflected in Treasury regulations, which provide that the Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance, but that the Commissioner may also consider the alternatives available to the taxpayer in determining whether the terms of the related-party transaction would be acceptable to an unrelated-party taxpayer faced with the same alternatives and operating under comparable circumstances.[564] As with specified methods, unspecified methods should reflect a consideration of the realistic alternatives to the actual transaction in connection with a transfer of intangibles.[565] Similar rules apply to unspecified methods for transfers of tangible property,[566] cost-sharing arrangements[567] and intercompany services.[568] Although the examples in the regulations mostly describe available, but not undertaken, internal transactions entirely within the related-party group,[569] the realistic alternative principle is not limited to such transactions.[570]

Permissible pricing methodologies

The regulations specify three methods that may be used to price a transfer of an intangible: comparable uncontrolled transaction ("CUT"), comparable profits method and profit split methods. The method chosen need not be one of the specified methods if an unspecified method is a more reliable measure.[571] An unspecified method must take into account the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. A taxpayer must apply any method, whether specified or unspecified, in accordance with the overall requirements of Treas. Reg. sec. 1.482-1, including its best method, comparability analysis and arm's length range rules.

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[563] Tech. Adv. Memo. 200907024.

[564] See, e.g., Temp. Treas. Reg. sec. 1.482-1T(f)(2)(ii).

[565] Treas. Reg. sec. 1.482-4(d)(1).

[566] Treas. Reg. sec. 1.482-3(e)(1).

[567] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iii).

[568] Treas. Reg. sec. 1.482-9 (h). See also Treas. Reg. secs. 1.482-1(d)(3)(iv)(H) and 1.482-3(b)(2)(ii)(B)(8).

[569] See Treas. Reg. secs. 1.482-1(f)(2)(iii)(B) Example; 1.482-4(d)(2)(ii) Example; and 1.482-3(e)(2) Example; and Temp. Treas. Reg. secs. 1.482-7(g)(2)(iv)(B) Examples.

[570] S*ee* Treas. Reg. sec. 1.482-9(h) Example (where the Commissioner determines that an intragroup service transaction involving password-controlled internet access to software is comparable to a similar arm's-length transaction involving the sale of, and uncontrolled access to, software through a download or the transfer of a diskette, the similar arm's-length transaction may be considered for purposes of determining whether the intragroup transaction achieves an arm's-length result*)*.

[571] Treas. Reg. sec. 1.482-4(d)(1).

The CUT method evaluates the amount charged for an intangible in a controlled transaction by reference to the amount charged in a comparable uncontrolled transaction (i.e., a transaction between unrelated parties).[572] If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction (i.e., an exact comparable), the CUT method generally is the most direct and reliable measure of the arm's length result for a controlled transaction.[573] Because exact comparables are rare in the case of high-value intangibles, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances (i.e., inexact comparables) may be used, but the results are less reliable. The taxpayer must consider whether the intangible that is the subject of the uncontrolled transaction has "similar profit potential" to the taxpayer's intangible in determining whether the uncontrolled transaction is comparable,[574] but does not otherwise consider the price actually charged for the taxpayer's intangible.

The remaining methods require an examination of the income actually derived from the transferred intangible. They differ, however, in the extent to which they rely on comparable uncontrolled transactions. The comparable profits method evaluates the amount charged in a controlled transaction by comparing the operating profit of the "tested party" (generally, the licensee) to the operating profits of uncontrolled taxpayers that engage in similar business activities under similar circumstances. For example, where a U.S. parent company licenses an intangible to a foreign manufacturing subsidiary, the royalty payable by the subsidiary to the parent is evaluated under this method by comparing the operating profit of the subsidiary to the operating profits of comparable uncontrolled manufacturers. If the subsidiary's profit level differs meaningfully from the profit levels of the uncontrolled manufacturers, the royalty rate paid by the subsidiary is adjusted as necessary to bring the profit level within an acceptable range of those levels. In effect, this method limits the extent to which the licensee can retain income from the intangible to the amount that an uncontrolled licensee would be permitted to retain; the remainder of that income is required to be paid to the licensor through the royalty.[575]

The regulations also provide two profit split methods under which the relative values of each controlled party's contribution to the combined profit from use of the intangible are used to determine an arm's length "profit split." The arm's length charge for the intangible is the amount required to achieve the appropriate split of the combined profits. The comparable profit split method relies exclusively on external market data to determine the appropriate profit split; thus, the combined operating profits of controlled taxpayers are split based on the split of combined operating profits of uncontrolled taxpayers with similar transactions and activities in the relevant business activity.[576] In contrast, the residual profit split method relies on external

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[572] Treas. Reg. sec. 1.482-4(c)(1).

[573] Treas. Reg. sec. 1.482-4(c)(2)(ii). Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made.

[574] Treas. Reg. sec. 1.482-4(c)(2)(iii)(B)(1)(ii).

[575] Treas. Reg. sec. 1.482-5, including Example (4).

[576] Treas. Reg. 1.482-6; Temp. Treas. Reg. sec. 1.482-6T(c)(2)(ii)(D).

transactions principally in order to determine the amount appropriately allocable to routine contributions and, in some cases, to determine the split of residual nonroutine return amongst the parties.[577] Under this method, income is first allocated to the routine contributions of the controlled parties (including contributions of routine intangibles) based on market returns, and the residual income is then allocated based on the relative value of each party's contribution of nonroutine property.

Periodic adjustments

Periodic adjustments may be required to comply with the commensurate with income requirement. When an intangible is transferred in a transaction that covers more than one year, the consideration charged for each taxable year may be adjusted by the IRS (in the context of an examination of that year) to ensure that it is commensurate with the income from the intangible. However, no adjustment is required in the following circumstances (subject to the taxpayer's meeting certain additional requirements): (1) the taxpayer established its initial transfer price relying on a CUT involving the same intangible, (2) the actual profits for the tax year do not exceed 120 percent of the prospective profits that were foreseeable at the time the transaction was entered into, (3) the actual profits exceed 120 percent of those foreseeable at the time the transaction was entered into, but only as a result of unforeseeable events beyond the control of the taxpayer, or (4) for the first five years of the transaction, actual profits do not exceed 120 percent of the prospective profits that were foreseeable at the time the participants entered into the transaction.

Cost-sharing arrangements

Cost sharing arrangements ("CSA") are defined and governed by the transfer pricing regulations.[578] A CSA is an arrangement under which controlled participants agree to, and in fact, share costs and risks of developing intangibles in proportion to their reasonably anticipated benefits. CSAs are not recognized as separate entities for purposes of the Code.[579] The IRS may impute a qualified arrangement in certain circumstances where there is a nonqualified arrangement.[580]

To qualify as a CSA, an arrangement must satisfy the conditions outlined in the regulation, including the division of interest in resulting intangibles and compensation for a participant's contributions evaluated using the "investor model." Under the division of interest rule, each participant must receive a non-overlapping interest in the intangible developed pursuant to the CSA, without obligation to provide additional compensation to other

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[577] "Routine" contributions (including routine intangibles) are generally contributions for which it is possible to identify market returns. Temp. Treas. Reg. sec. 1.482-6T(c)(3)(i)(A).

[578] Temp. Treas. Reg. sec. 1.482-7T.

[579] Treas. Reg. sec. 301.7701-1(c).

[580] Temp. Treas. Reg. sec. 1.482-7T(i)(5).

participants.[581] Under the investor model, each participant is treated as an investor in the cost-sharing activity who expects to earn a return on its aggregate investment of cash, including both its ongoing share of the intangible development costs and its platform and operating cost contributions.[582] The investor's anticipated return must take into account all material functional and risk allocations, such as the scope of intangible development activity, in order to ensure that the results of the CSA are consistent with the arm's length standard.[583]

There are five methods for valuing buy-in payments within the context of the investor model. The comparable uncontrolled price method references a comparable cost sharing arrangement with an uncontrolled party.[584] The income method examines the present value of the projected income from the contributing participant's best realistic alternative.[585] The acquisition price method considers the acquisition price of a contributed intangible that was recently acquired in an arm's length transaction.[586] The market capitalization method determines the parent company's stock market capitalization, increased for its liabilities as of the buy-in date and reduced for the value of tangible property and non-covered intangibles.[587] The final specified method, the residual profit split method, applies only where more than one participant makes significant, nonroutine contributions.[588] In addition to these specified methods, use of an unspecified method is authorized if its use produces a more reliable arm's-length result.[589]

In addition to the investor model, the realistic alternative principle is expressly made applicable to CSAs,[590] workforce-in-place is identified as a separately compensable intangible if it is reasonably expected to contribute to the development of the cost-shared intangibles,[591] the

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[581] Temp. Treas. Reg. sec. 1.482-7T(b)(1)(iii).

[582] Temp. Treas. Reg. sec. 1.482-7T(j)(1)(i).

[583] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(ii).

[584] Temp. Treas. Reg. sec. 1.482-7T(g)(3).

[585] Temp. Treas. Reg. sec. 1.482-7T(g)(4). On September 27, 2007, the IRS issued a Coordinated Issue Paper which stated that the income method is generally the best method for valuing initial buy-in payments. "*Coordinated Issue Paper Addresses Cost Sharing Arrangement Buy-In Adjustments,*" Section III.B., LMSB-0400907-62 (Sept. 27, 2007), available at http://www.irs.gov/businesses/article/0,,id=174320,00.html.

[586] Temp. Treas. Reg. sec. 1.482-7T(g)(5). The acquisition price of the intangible is derived from the price paid for the stock or assets of a target that owned the intangible.

[587] Temp. Treas. Reg. sec. 1.482-7T(g)(6).

[588] Temp. Treas. Reg. sec. 1.482-7T(g)(7). Under the residual profit split method, the residual divisional operating profit or loss of each participant (after allocations of market returns to routine contributions, operating cost contributions and intangible development cost contributions) is allocated based on the relative value of its non-routine contribution, determined by reference to external benchmarks or the capitalized cost of development.

[589] Temp. Treas. Reg. sec. 1.482-7T(g)(8).

[590] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iii).

[591] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(vii)(B), Example 1, part (ii).

circumstances under which the IRS may make periodic adjustments to buy-in payments were revised and transition rules are provided. The IRS may make periodic adjustments if it determines that the payor's returns are outside a specified "periodic return ratio range," subject to various exceptions under which no adjustment is required.

All CSAs are subject to the present law requirements in general. To the extent that an intangible development arrangement does not meet the requirements to be considered a CSA under the present CSA regulations, such arrangement is governed by the rules provided in other sections of the transfer pricing rules. A pre-effective date arrangement may qualify as a CSA under the present law requirements[592] and be eligible for certain exceptions to the present rules governing periodic adjustments[593] and the division of interest rule.[594] In general, any platform contribution made to a qualified arrangement is subject to the periodic adjustment rules that generally apply to intangible property.[595] However, if there is a material change in the scope of a qualified arrangement, any subsequent platform contribution made to a qualified arrangement is subject to the periodic adjustment rules of the 2008 regulations and does not qualify for the special rules provided in the transition rule.[596]

Description of Proposal

The proposal states that it clarifies that the definition of intangible property for purposes of sections 367(d) and 482 includes workforce in place, goodwill and going concern value. The proposal also states that it clarifies that in a transfer of multiple intangible properties, the Commissioner may value such properties on an aggregate basis where doing so achieves a more reliable result. Finally, the proposal states that it clarifies that the Commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

The proposal does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property. Instead, its scope is limited to addressing certain definitional and methodological issues that have arisen in controversies with respect to

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[592] Temp. Treas. Reg. sec. 1.482-7T(m)(1) prescribes certain transitional steps to be completed in 2009 by a pre-existing arrangement in order to qualify as a CSA.

[593] Temp. Treas. Reg. sec. 1.482-7T(m)(2)(ii). An existing cost-sharing arrangement qualified as a cost-sharing arrangement is subject to the periodic adjustment rules of Treas. Reg. sec. 1.482-(f)(2).

[594] Temp. Treas. Reg. sec. 1.482-7T(m)(2)(iii).

[595] See Treas. Reg. sec. 1.482-(f)(2) for this rule.

[596] Temp. Treas. Reg. sec. 1.482-7T(m)(3).

the value attributed to intangible property at the time it is transferred outside the United States, both with respect to buy-in payments[597] for existing intangible property made available to related affiliates pursuant to cost-sharing arrangements and in connection with outbound restructurings of U.S. manufacturing operations. Both the proper identification of the relevant intangible and its appropriate valuation were presented in *Veritas v. Commissioner*,[598] an opinion that illustrates the difficulties inherent in both issues.

Expanding the list of specified items in definition of intangible property

The proposal answers the question of whether the value attributable to goodwill, going concern value, and workforce-in-place in outbound transfers to related parties requires compensation. By casting the proposal as a clarification, the Administration is also attempting to establish that present law also requires compensation for such transfers. Some commentators have expressed the view that the proposal represents a significant change to present law,[599] a view accepted in dicta in *Veritas v. Commissioner.* In its opinion, the Tax Court stated that "there was no explicit authorization of the [IRS's…] inclusion of workforce in place, goodwill, or going-concern value" in calculating the allocation to the buy-in payment, relying, without further explanation, on the existence of a positive revenue estimate for an earlier iteration of the Administration proposal in 2009.[600] To the extent that the proposal is a clarification, the proposal is consistent with the position the Administration has taken in litigation and regulations that workforce in place, goodwill, and going concern value are items similar to the types of intangible property listed in section 936(h)(3)(B) and thus within the definition of intangible property.[601] The proposal does not resolve the status of such residual intangibles under present law.

With regard to goodwill and going concern value, IRS audit disputes concern the threshold treatment of these items as intangibles, the scope of the exception under section 367(d) for foreign goodwill or going concern value, and the extent to which the exception under section 367(d) should be imputed to section 482. Questions include how to distinguish foreign goodwill or going concern value from U.S. goodwill and going concern value, where both are

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[597] Cost-sharing buy-in payments were designated as a Tier I compliance issue on April 5, 2007. See *"*Industry Director Directive #1 on Transfer of Intangibles Offshore/ §482 Cost-sharing Buy-in Payment*,"* LMSB Control No: LMSB-04-0307-027, available at http://www.irs.gov/businesses/article/0,id=169313,00.html.

[598] 133 T.C. No. 14 (December 10, 2009), non-acq., IRB 2010-49 (December 6, 2010).

[599] See, e.g., Molly Moses and Rita McWilliams, *"*Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles*," BNA Daily Tax Report* (May 18, 2009) (hereafter, "Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles").

[600] See footnote 25 and the accompanying text in *Veritas v. Commissioner*, 133 T.C. No 14, 32, 2009 WL 472360 (December 10, 2009), in which the Court acknowledged that the estimate encompassed more than the definition clarification alone. The Court provides no basis for its implied conclusion that a clarification of the law would not have an effect on revenue.

[601] See sec. 936(h)(3)(B)(vi); see also Treas. Reg. sec. 1.482-4(b)(6), which states that "an item is considered similar to those listed … if it derives its value not from its physical attributes but from its intellectual content or other intangible properties."

transferred,[602] and whether foreign goodwill or going concern value is an attribute of foreign operations that develops over time. The IRS asserts that foreign goodwill or going concern value has no value at the start-up of foreign operations.[603]

If one concludes that sections 482 and 367(d) address economically similar events and should therefore be construed consistently, one may conclude that the property excepted from compensation under section 367(d) should also be excepted under section 482. Such an exception is not referenced in the statute, legislative history, or the regulations. Commentators who adopt that position also contended that the addition of goodwill and going concern value to the definition of intangible property under section 936(h)(3)(B) renders obsolete the exception for foreign goodwill or going concern value set forth in Temp. Treas. Reg. sec. 1.367(d)-1T(b).[604] This conclusion is predicated, however, on the position that specifically identifying goodwill and going concern value as intangible property under section 936(h)(3)(B) is a change in law, rather than a clarification of present law. The description of the proposal as a clarification of (and not as a change to) present law suggests that the proposal is not intended to revoke the exception. In any event, the question could easily be addressed by incorporating an explicit exception for transfers of foreign goodwill or going concern value in the implementing legislation, if Congress wishes to preserve the exception.

With regard to workforce in place, IRS audit disputes include both whether it is a "similar item" under section 936(h)(3)(B)(vi) and, if so, whether it is a component of goodwill or going concern value or a separately identifiable asset. Some taxpayers argue that, if it exists at all (as intangible property beyond its physical element), workforce in place is a component of goodwill and going concern value and, consequently, transfers of a foreign workforce in place are non-compensable under section 367(d).[605] In contrast, the IRS takes the position that any identifiable intangible with substantial value independent of the services of any particular individual is, by definition, not goodwill or going concern value.[606] Thus, any workforce in place (such as a research and development team that is made available to a cost-sharing arrangement) that has substantial value independent of the services of any individual member of that workforce also

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[602] See Molly Moses and Rita McWilliams, *"Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles."*

[603] See, e.g., "LMSB Procedures for Program Action Cases (PACs) on Tax Return Preparers," LMSB-04-0108-001 (February 13, 2008) reprinted at *Tax Notes Today* 36-42, (February 22, 2008) ("The definition of foreign goodwill or going concern value requires a business operation conducted outside of the United States."); see also, "Coordinated Issue Paper Addresses Cost-sharing Arrangement Buy-In Adjustments," section III.E.1., LMSB-0400907-62 (September 27, 2007), available at http://www.irs.gov/businesses/article/0,id=174320,00.html (hereafter, "2007 IRS *Coordinated Issue Paper*").

[604] See, e.g., James P. Fuller, "U.S. Tax Review," 54 *Tax Notes International* (June 1, 2009), p. 776.

[605] See, e.g., "Audit Guidelines Related to Section 936 Conversion Issues, Attachment to Industry Directive on Section 936 Exit Strategies Audit Guidelines Related to Section 936 Conversion Issues," Step 2.d., available at http://www.irs.gov/businesses/corporations/article/0,id=167559,00.html; see also, 2007 IRS Coordinated Issue Paper, Section III.E.

[606] See sec. 936(h)(3)(B), flush language and Treas. Reg. sec. 1.482-4(b)(6); see also 2007 IRS Coordinated Issue Paper, Section III.E.1.

has an intangible component that is distinct from goodwill and going concern value and compensable by the person for whose benefit it is used.[607]

Valuation issues

A second set of issues arise when the IRS and taxpayer agree that a compensable intangible asset has been transferred offshore, but differ on the most reliable valuation technique.[608] Two common issues involve the appropriateness of valuing groups or series of transactions in the aggregate and the determination of whether there was an alternative that the transferor could have realistically pursued. The nature of these disputes and how the proposal would address each is discussed below.

Aggregation v. asset-by-asset valuation

In certain cases, a taxpayer may believe that the most reliable method is to value intangible properties individually, on an asset-by-asset basis, without reflecting the enhanced value that may arise from their interrelationship. Where the IRS believes this method leads to unreliable results, the IRS may dispute this asset-by-asset valuation approach. Instead, it may take the position that the individual assets are so closely related that the individual pieces cannot be reliably valued on an asset-by-asset basis and that the relevant intangible property is the aggregation of the interrelated assets.

The question presented in aggregate valuation cases is whether the enhanced value that, in some situations, results from the interrelation of identifiable intangible assets when they are grouped together can be attributed properly to those intangible assets. In the cost-sharing context, attributing the enhanced value to identifiable intangible assets results in a greater buy-in payment. If the enhanced value cannot be attributed to identifiable intangible assets, then the enhanced value is instead attributed to goodwill or going concern value. In the context of an outbound reorganization, the improper attribution of enhanced value to foreign goodwill or going concern value may, in many cases, understate the actual value of the underlying intangible assets and result in inadequate compensation under section 367(d).[609]

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[607] See, e.g., 2007 IRS Coordinated Issue Paper, *Section III.E.3; "*Notice of Proposed Rulemaking and Notice of Public Hearing Section 482: Methods to Determine Taxable Income in Connection With a Cost-sharing Arrangement*,"* 2005-2 C.B. 625, 627 (hereafter "2005 Proposed Section 482 CSA Regulations").

[608] See, e.g., Tech. Adv. Memo. 200907024 (the IRS rejected a taxpayer's valuation of a network of contracts assigned to a foreign affiliate, in which the taxpayer valued each contract separately).

[609] In the context of section 367(d), taxpayers may also argue that requiring taxable compensation for the value of synergies among different intangibles is, in effect, to impose a tax on the value of the opportunity to conduct a business overseas, which, it is argued, has not previously been taxable under the principles of Section 367. See, e.g., *Hospital Corp. of America v. Commissioner*, 81 T.C. 520, 590 (1983) (no section 367 ruling was required because the petitioner did not transfer property to its foreign affiliate when the petitioner presented the affiliate with an opportunity to enter into a contract); David R. Hardy, *"*Assignment of Corporate Opportunities − The Migration of Intangibles*," Tax Notes* 100 (July 28, 2003), pp. 527, 532-539.

The proposal is consistent with the position that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result. This approach is also consistent with Tax Court decisions in cases outside of the section 482 context, where collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate.[610] Finally, it conforms with the position taken in the recently issued cost-sharing regulations.[611]

In *Veritas v. Commissioner*, the Tax Court rejected the use of the aggregation by the IRS for purposes of valuing a transfer of intangible property. The Court noted that the use of the aggregation approach is permitted if it produces the most reliable means of determining the arm's-length consideration in related party transactions. The Court stated that the effect of aggregation was to value assets with short lives as if they had perpetual lives, as well as to value subsequently developed assets that were not transferred. As a result, the Court concluded that the aggregation approach did not, in that case, produce the most reliable result.[612]

The issue was the adequacy of the lump-sum payment made by a cost-sharing participant for use of the intangibles the taxpayer had made available through a cost-sharing arrangement. The taxpayer's Irish affiliate made a buy-in payment of $118 million as a royalty for the use of a full-range of pre-existing intangible property. The royalty was determined based on internal comparable transactions, in which the taxpayer had licensed the same intangible property to unrelated parties. However, none of the internal comparables licensed the same full range of rights as were bundled together and made available under the cost-sharing arrangement, although collectively the agreements involved essentially the same intangible property. The IRS challenged the comparability of the internal transactions on which the taxpayer based its determination of the transfer price, contending that the rights granted in of each third-party license were materially narrower than those made available through the Irish affiliate through the cost-sharing arrangement. The IRS also argued that the most reliable method for valuing the bundle of rights that were transferred was as an aggregation of rights. Further, the IRS contended that the taxpayer should have been compensated for the transfer of existing goodwill, going-concern value, and workforce in place to the Irish affiliate.

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[610] See, e.g., *Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Commissioner*, 25 B.T.A. 281, p. 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

[611] See Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iv) (if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

[612] 133 T.C. No 14, 40-41, non-acq., IRB 2010-49 (December 6, 2010).

There is no indication that the Tax Court's decision in *Veritas* would have been different if the aggregation principle had been adopted by statute, rather than by regulations. The Administration may believe that taxpayers will be more likely to apply aggregation in the first place, and that IRS field agents may meet less resistance in applying the aggregation on audit if it is codified. However, the Court observed in *Veritas* that the effect of aggregation was to convert the license of intangible property into a sale, which would have dramatically increased the buy-in payment due from the Irish affiliate.[613] To the extent aggregation generally has the effect of converting a license into a sale and dramatically increasing the transfer price (in this case, the proposed adjustment exceeded $2 billion), taxpayers have a financial incentive to find that some other valuation method is the most reliable application of that method. This is the case whether aggregation is codified or not. Thus, in the absence of any challenge to the validity of the regulations, it is unclear why codification of aggregation is required to reinforce the existing regulation.

Realistic alternative principle

In other cases, a taxpayer may assert a transfer price as an arm's-length result without also considering any realistic alternative to the transaction actually undertaken, such as the alternatives of making a product directly or outsourcing production. If the taxpayer fails to consider realistic alternatives, the IRS may conclude that the taxpayer has not achieved an arm's-length result, because the taxpayer has assumed that an unrelated person at arm's-length would be willing to engage in a particular transaction, even if an available alternative would yield a greater economic return.[614]

The proposal also codifies the realistic alternative principle with respect to intangible property. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. As a result, the existing regulations provide the IRS with the ability to determine an arm's-length price by reference to a transaction (such as the owner of an intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee). The realistic alternative principle assumes that taxpayers act in an economically rational manner and uses this assumption as the basis for identifying transfer pricing that does not reflect an arm's-length result.

For example, a taxpayer may report income of only $100 under one pricing method with respect to a transaction with a related party. If the IRS determines that a realistic alternative available to the taxpayer would have generated $1,000, the IRS will propose an adjustment. As the basis for its adjustment, the IRS will assert that the taxpayer's $100 of income is not an arm's-length result because unrelated parties, dealing at arm's-length, would not settle for less than $1,000.

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[613] *Ibid.*

[614] See, e.g., 2005 Proposed Section 482 CSA Regulations, 633.

In making its determination, the Commissioner evaluates the data provided by any available internal comparables (actual transactions between the taxpayer and third parties) and external comparables (actual transactions between unrelated parties), as well as information regarding the return to the property owner that could have been realized if the property owner had taken an alternative, but realistic, course of action in deploying the asset internally. If, when considering the data it is determined that the transfer price of a non-existent internal transaction differs materially from the transfer price of the actual controlled party transaction, the Commissioner may conclude that the taxpayer's transfer pricing of the actual transaction does not reflect an arm's-length result.

The realistic alternative principle was first adopted in final regulations issued in 1994,[615] following taxpayer-favorable court decisions. In *Bausch & Lomb,*[616] the IRS disputed the comparability of the uncontrolled transactions proffered by the taxpayer and argued that the Irish licensee of the "spin cast" method of manufacturing soft contact lenses was only entitled to a contract manufacturer return because its U.S. parent, the licensor, would not have been willing to pay an independent third party much more than the cost of producing the contact lenses itself. This so-called "make or buy" argument was rejected by the court, in part due to the preference given to one method over another in the then-existing regulations.[617] However, subsequently issued Treasury regulations address the application of the realistic alternative rule for intangible property in an example analogous to the facts of *Bausch & Lomb.* In the example, a taxpayer licenses a proprietary process for making a product known as "Longbond" to its foreign subsidiary.[618] In determining whether consideration paid with respect to the license is arm's-length, the IRS expressly considers (subject to the best-method rule) the taxpayer's alternative of producing and selling "Longbond" itself.[619]

OECD Transfer Pricing Guidelines include the realistic alternative principle. For example, the OECD's general guidance for analyzing comparability under the arm's-length standard incorporates the realistic alternative concept, stating that "[i]ndependent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive."[620] Similarly, in the context of business restructurings, the OECD concluded that the factors relevant to determining whether a transfer is an arm's-length transaction include "the options that would have been realistically available to the

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[615] T.D. 8552, 1994-2 C.B. 93.

[616] 933 F.2d 1084 (2d. Cir. 1991).

[617] *Ibid.*, p. 1089.

[618] Treas. Reg. sec. 1.482-4(d)(2)(ii). See also Treas. Reg. sec. 1.482-1(f)(2)(ii)(B), Example (incorporating by reference the analysis in the example set forth in Treas. Reg. sec. 1.482-4(d)(2)(ii)).

[619] See also Temp. Treas. Reg. sec. 1.482-7(g)(2)(iv)(B), Examples.

[620] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* I-12, ¶1.15.

transferor and transferee at arm's-length, based on the rights and other assets of each at the outset of the restructuring, that determine the profit/loss potential of either."[621]

To date, there are no legal decisions that analyze or discuss the realistic alternative provisions of the regulations. Accordingly, it is unclear how codification of this regulation will advance administration of the transfer pricing cases or why codification is necessary to reinforce these particular existing regulations.

Other possible approaches

The proposal addresses several definitional and methodological issues, thereby improving the administration of the existing transfer pricing rules. However, the transfer pricing rules applicable to intangible property coupled with the deferral regime have the potential to facilitate erosion of the U.S. income tax base.[622] Other proposals included in the Administration's budget—in particular those relating to the deferral of expense deductions, foreign tax credit blending, and elimination of deferral on excess offshore profits—may reduce incentive to attempt to shift income inappropriately. However, as discussed further in the analysis of those proposals, they would have uneven effects.

This raises the question of whether the Administration's proposal sufficiently addresses the problems in applying the transfer pricing rules, or whether broader reform of the existing rules is necessary. The proposal does not alter the commensurate with income standard, nor does it address the extent to which the existing transfer pricing regulations appropriately implement the commensurate with income principle. Clarification of that principle by the addition of objective and observable factors to determine when income is attributable to an intangible is desirable to avoid future controversies about other aspects of definitions and methodology in transfer-pricing. Finally, the appropriateness of respecting cost sharing arrangements among related parties could be explored.

Although the temporary cost sharing regulations are intended to mitigate abusive cost sharing practices and address criticisms that application of the commensurate with income principle conflicts with the arm's length standard, they do so within the context of the existing framework. Arguably, however, that framework may unintentionally encourage U.S.-based multinational groups to develop intangible property offshore and to shift the economic ownership of developed intangible property to CFCs by prescribing terms under which internal cost sharing arrangements will be respected despite the lack of any comparable arrangement among unrelated parties. Consistent with the 1986 legislative history, the cost sharing regulations seek to establish an arm's length price for these arrangements, even though comparable arrangements

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[621] *OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* ¶¶ 9-59 to 9-64.

[622] For a review of six case studies that identify and discuss business structures that may affect a taxpayer's U.S. and worldwide tax liability, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010. This document is available on the internet at www.jct.gov.

rarely occur between uncontrolled parties.[623] Examining the extent to which the existing framework encourages outbound transfers of intangible property may lead to reconsideration of the merits of respecting cost sharing arrangements and suggest a new, more limited framework.

Prior Action

A similar proposal was included in the administration's revenue proposals for fiscal years 2010 and 2011.

5. Disallow the deduction for nontaxed reinsurance premiums paid to affiliates

Present Law

Insurance companies in general

Subchapter L of the Code provides special rules for determining the taxable income of insurance companies. Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to tax at regular corporate income tax rates.

Life insurance companies

For Federal income tax purposes, an insurance company is treated as a life insurance company if the sum of its (1) life insurance reserves and (2) unearned premiums and unpaid losses on noncancellable life, accident or health contracts not included in life insurance reserves, comprise more than 50 percent of its total reserves.[624]

Reserves

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[625] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

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[623] For example, the IRS noted in the preamble to the 2005 proposed cost sharing regulations that "[c]omment letters and other information available to the Treasury Department and IRS have provided limited information on third-party arrangements that are asserted to be similar to cost sharing arrangements. Typically, in the context of discussion concerning the current sec. 1.482-7 regulations, information has been provided on certain arrangements involving cost plus research and development or government contracts, which, while no doubt arm's length transactions, are not viewed by the Treasury Department and IRS as analogous to cost sharing arrangements." 2005 Proposed CSA Regulations, 626.

[624] Sec. 816(a).

[625] Sec. 807.

Reinsurance premiums

A deduction is permitted for consideration − including reinsurance premiums − paid in respect of assumption of liabilities under insurance and annuity contracts.[626]

Proration of deductions for untaxed income

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends received deduction only in proportion to the company's share of such dividends. For this purpose, the policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is determined in relation to net investment income of the company.[627]

Property and casualty insurance companies

Under present law, the taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[628] For this purpose, underwriting income and investment income are generally computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC.[629]

Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.[630] Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). Present law provides for the discounting of the deduction for loss reserves to take account partially of the time value of money.[631] Thus, present law limits the deduction for unpaid losses to the amount of discounted unpaid losses. Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

The discounted reserves for unpaid losses are calculated using a prescribed interest rate that is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the

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[626] Sec. 805(a)(6).

[627] Sec. 812.

[628] Sec. 832.

[629] Sec. 832(b)(1)(A).

[630] Sec. 832(b)(3).

[631] Sec. 846.

average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

Reinsurance premiums deductible

In determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance.[632]

Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year.[633] The company is required to reduce the deduction for increases in unearned premiums by 20 percent. This amount serves to represent the allocable portion of expenses incurred in generating the unearned premiums, so as to provide a degree of matching of the timing of inclusion of income and deduction of associated expenses.

Proration of deductions relating to untaxed income

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.[634] This rule reflects the fact that reserves are generally

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[632] Sec. 832(b)(4)(A).

[633] Sec. 832(b)(4)(B). Unearned premiums are generally those premiums received for insurance coverage in a future taxable year of the insurance company.

[634] Sec. 832(b)(5).

funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

Treatment of reinsurance

In general

Present law includes a rule enacted in 1984 providing authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion.[635]

The rule permits the Treasury Department to make reallocations in related party reinsurance transactions. The rule was amended in 2004 to provide the Treasury Department with additional authority to allocate among the parties to a reinsurance agreement or to recharacterize income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and any other items related to the reinsurance agreement, or to make any other adjustment to reflect the proper source, character, or amount of the item.[636] In expanding this authority to the amount (not just the source and character) of any such item, Congress expressed the concern that "reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons," and that "foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."[637]

The rule also provides that if the Secretary determines that a reinsurance contract between insurance companies, whether related or unrelated, has a significant tax avoidance effect on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. The legislative history provides that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, appropriate factors for the Treasury Department to take into account are (1) the duration or age of the business reinsured, which bears on the issue of whether significant economic risk is transferred between the parties, (2) the character of the business (as long-term or not), (3) the structure for determining potential profits, (4) the duration of the reinsurance agreement, (5) the parties rights to terminate and the consequences of termination, such as the existence of a payback provision, (6) the relative tax positions of the parties, and (7) the financial situations of the parties.[638]

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[635] Sec. 845. See Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

[636] Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[637] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, (JCS-5-05), May 2005, p. 351; Senate Finance Committee Report to S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. No. 108-192, November 7, 2003, p.161.

[638] Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H.R. Rep. No. 98-861, June 23, 1984, p. 1063-4. In *Trans City Life Insurance Company v. Commissioner*, 106 T.C. 274 (1996), nonacq., 1997-2

Reinsurance premiums received by foreign persons

The United States employs a worldwide tax system under which U.S. persons (including U.S. citizens, U.S. resident individuals, and domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including nonresident alien individuals and foreign corporations) are taxed in the United States only on income that has a sufficient nexus to the United States.

Foreign tax credit

A foreign tax credit is provided for income and withholding taxes paid to a foreign country, to prevent taxation of the income both in the United States and in the other country. The amount of the credit is subject to a foreign tax credit limitation, which provides generally that the credit is limited to the amount of the taxpayer's U.S. tax on foreign-source income. The foreign tax credit limitation is generally computed separately for income in two categories: passive and general. Excess credits may be carried back one year and forward 10 years.

Effectively connected income

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States.[639] Such income may be derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. For this purpose, deductions are allowed only if and to the extent that they are connected with the income that is effectively connected with the conduct of a trade or business within the United States. In addition, foreign persons generally are subject to U.S. tax withheld at a 30-percent rate on certain gross income (such as interest, dividends, rents, royalties, and premiums) derived from U.S. sources.[640]

A foreign company carrying on an insurance business in the United States that would be treated as a life insurer or a property and casualty insurer for Federal tax purposes if it were a domestic corporation is subject to U.S. tax under subchapter L on its income effectively connected with its conduct of any trade or business within the United States.[641] Special rules apply to calculate the minimum effectively connected net investment income for this purpose.[642]

C.B. 1, the Tax Court held that two reinsurance agreements did not have significant tax avoidance effects, based on the application of these factors.

[639] Sec. 882.

[640] Sec. 881.

[641] Sec. 842.

[642] Sec. 842(b). In *North West Life Assurance Co. of Canada v. Commissioner*, 107 T.C. 363 (1996), the Tax Court held that the business profits article of the United States-Canada income tax treaty permits a Canadian insurer doing business in the United States through a U.S. permanent establishment to attribute income to the permanent establishment based on its "real facts," not under the minimum investment income calculation of section 842(b).

30-percent gross basis withholding

Other U.S.-source income of such a foreign company carrying on an insurance business in the United States is subject to the 30-percent gross-basis withholding tax applicable generally to U.S.-source income of any foreign corporation.

Treasury regulations provide, however, that insurance premiums subject to the insurance or reinsurance excise tax (described below) are not subject to the 30-percent gross-basis withholding requirement applicable for income tax purposes.[643]

Securities trading safe harbor

Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[644] Under these rules (colloquially referred to as trading safe harbors), trading in stock or securities or commodities by a foreign person through an independent agent such as a resident broker generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trading is effected. Trading in stock or securities or commodities for the foreign person's own account, whether by the foreign person or the foreign person's employees or through a resident broker or other agent (even if that agent has discretionary authority to make decisions in effecting the trading) also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock or securities or commodities.

Exemption from 30-percent withholding for certain investment income

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.[645] Original issue discount on obligations maturing in six months or less is also exempt from tax.[646] An additional exception is provided for certain interest paid on portfolio obligations.[647] Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder.[648] This exception is not available for any interest received

[643] Treas. Reg. sec. 1.1441-2(a)(7); see also Treas. Reg. sec. 1.881-2(b).

[644] Sec. 864(b)(2).

[645] Secs. 871(i)(2)(A), 881(d).

[646] Sec. 871(g)(1)(B)(i).

[647] Secs. 871(h), 881(c).

[648] Sec. 871(h).

either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person.[649] Moreover, this exception is not available for certain contingent interest payments.[650]

Subpart F

Under the subpart F rules,[651] 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income (including foreign personal holding company income). The subpart F rules generally do not apply in the case of a foreign corporation that is controlled by foreign persons.

Active financing exception under subpart F

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[652] In general, the availability of the exception for income derived in the active conduct of a banking, financing, or similar business requires that the CFC directly receive at least 70 percent of its gross income from the active and regular conduct of a lending or finance business from transactions with customers who are unrelated persons. Similarly, the exception for income derived in the active conduct of an insurance business generally applies only to income received from unrelated persons.

Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation.[653] The branch level taxes are comparable to these second-level taxes. In

[649] Sec. 881(c)(3).

[650] Sec. 871(h)(4).

[651] Secs. 951-965.

[652] Secs. 953(e) and 954(h) and (i), which expires December 31, 2011.

[653] Sec. 884.

addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

Insurance and reinsurance excise tax

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[654] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Exemption from the excise tax

The United States has entered into comprehensive income tax treaties with more than 50 countries, including a number of countries with well-developed insurance industries such as Barbados, Germany, Switzerland, and the United Kingdom. The United States has also entered into a tax treaty with Bermuda, another country with a significant insurance industry, which applies only with respect to the taxation of insurance enterprises.[655]

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[656] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[657]

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[654] Secs. 4371-4374.

[655] The U.S.-Bermuda treaty generally exempts from U.S. taxation the business profits of a Bermuda insurance enterprise from carrying on the business of insurance (including insubstantial amounts of income incidental to such business), unless the insurance enterprise carries on business in the United States through a U.S. permanent establishment. For the purposes of the treaty, an insurance enterprise is defined as an enterprise whose predominant business activity is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business. The treaty also includes a mutual assistance provision.

[656] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[657] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the Revenue Ruling provides that the excise tax still applies to both payments to the extent that the

The U.S. tax treaties with Barbados and Bermuda also provide an exemption from the excise tax, although the Senate's ratification of the U.S.-Bermuda treaty was subject to a reservation with respect to the treaty's application to the excise tax. Moreover, section 6139 of the Technical and Miscellaneous Revenue Act of 1988 provides that neither the U.S.-Barbados nor the U.S.-Bermuda treaty will prevent imposition of the excise tax on premiums, regardless of when paid or accrued, allocable to insurance coverage for periods after December 31, 1989.[658] Accordingly, no exemption from the excise tax is available under those two treaties with respect to premiums allocable to insurance coverage beginning on or after January 1, 1990.

Earnings stripping rules

A foreign parent corporation with a U.S. subsidiary may seek to reduce the group's U.S. tax liability by having the U.S. subsidiary pay deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although the United States generally subjects foreign corporations to a 30-percent withholding tax on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned domestic corporations may seek to use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.[659]

Present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. A deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor" ratio); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).[660] Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

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transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the Revenue Ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

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

[659] For example, it appears that the U.S.-Barbados income tax treaty was used to facilitate earnings stripping arrangements in the context of corporate inversions. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and Barbados* (JCX-55-04), September 16, 2004, pp. 12-20, 22.

[660] Sec. 163(j).

The earnings stripping rules generally apply to interest, but do not apply to other deductible payments such as insurance or reinsurance premiums.

Description of Proposal

General rule

The proposal disallows any deduction to covered insurance companies for the full amount of reinsurance premiums paid to foreign affiliated insurance companies if the premium is not subject to U.S. income taxation. The proposal provides a corresponding exclusion from income for reinsurance recovered with respect to a reinsurance arrangement for which the premium deduction has been disallowed. The proposal also provides an exclusion from income for ceding commissions received with respect to a reinsurance arrangement for which the premium deduction has been disallowed. The exclusions are intended to apply only to the extent the corresponding premium deduction is disallowed.[661]

Covered insurance company

A covered insurance company for this purpose is any company subject to U.S. income tax as an insurance company. Thus, for example, a property and casualty insurance company subject to tax in the United States is considered a covered insurance company under the proposal. The fact that a company has no U.S. income tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to tax. It is understood that all domestic members of a controlled group of corporations (as defined in section 1563, but using a 50-percent ownership threshold) of which a covered insurance company is a member are treated as one corporation.

The excise tax under section 4371 is disregarded for purposes of determining whether an affiliated insurance company is subject to U.S. income taxation.[662] Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to U.S. income tax as an insurance company, is not considered an affiliated insurance company subject to U.S. income taxation for purposes of this proposal.

Election to treat specified reinsurance income as effectively connected

The proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. This election is intended to provide that these foreign affiliates are not treated less favorably than U.S. reinsurers, in the event that the proposal could be viewed as discriminatory

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[661] The proposal states that the exclusions for reinsurance recovered and ceding commissions are allowed "in the same proportion that the premium deduction was denied." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, p. 46.

[662] Although this is not specified in the proposal, it is understood that this is the intent.

under the nondiscrimination article of any U.S. tax treaty. Under the election, the deduction disallowance for reinsurance premiums and the exclusion for related reinsurance recoverable and ceding commissions otherwise applicable under the proposal do not apply.

The election provides that an affiliated corporation treats certain premiums and certain net investment income as effectively connected with the conduct of a trade or business in the United States, and to be treated as carrying on an insurance business within the United States. Thus, it is understood that under the proposal, an electing company is subject to the rules of present-law section 842 governing effectively connected income of foreign insurance companies carrying on an insurance business in the United States. As under present law, for purposes of this election, deductions are allowed only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States.

For purposes of the election, specified reinsurance income means, with respect to any taxable year, (1) all reinsurance premiums for which (but for this election) a deduction would be disallowed and that are received by a corporation during the taxable year directly or indirectly from covered insurance companies with respect to which the corporation is affiliated, and (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums with respect to which an election applies (whether for the current or a prior taxable year). The election may be revoked only with the consent of the Secretary.

For purposes of the foreign tax credit, however, the proposal provides that specified reinsurance income treated as effectively connected under the election is treated as foreign source income and is placed in a separate category for purposes of the section 904 limitation on the foreign tax credit.

Effective date.−The proposal is effective for contracts issued in taxable years beginning after December 31, 2011.

Analysis

Earnings stripping

The proposal reflects a concern with earnings stripping through the use of reinsurance transactions between related parties. Earnings stripping reduces the U.S. tax base through transactions involving deductible payments to foreign entities that are not subject to U.S. tax, generally to those that are related to the U.S. payor. Reinsuring risks with insurance affiliates generally can have the effect of reducing U.S. tax on profits with respect to reinsured risks.[663]

Because U.S. tax accounting rules applicable to insurance companies provide a deduction for additions to insurance reserves, investment earnings on insurance company reserves can be

[663] Profits of an insurer can include both investment earnings on reserve amounts and underwriting profits.

viewed as tax-favored.[664] The proposal addresses the point that the use of affiliated reinsurers is a means by which U.S. insurance risks migrate to offshore reinsurance markets so as to avoid U.S. tax on reserve earnings. The proposal, structured as a deduction disallowance rule paired with exclusions for subsequent reinsurance recovered and ceding commissions, effectively provides for deferral of the deduction for premiums for reinsurance with foreign affiliates.

Primary insurers have a variety of reasons for reinsuring some of their business. A principal reason is to shift risk, because an insurer's pool of risks is too concentrated in some manner. Additional nontax reasons for engaging in reinsurance transactions − whether assuming or ceding risks through reinsurance transactions − involve reduction in business volatility by managing exposure to extremely large losses,[665] compliance with State regulatory requirements for capital and surplus, financing for growth of existing and new lines of business, [666] and diversification by acquisition or divestiture of blocks of business or entire lines of business.[667]

Further, there are nontax reasons for reinsurance transactions with affiliates, including foreign affiliates. These nontax reasons include moving or centralizing capital within a corporate group to maximize efficient capital management, as well as reduction in the cost of reinsuring risks because the affiliates know more about each other and about the risks than do unrelated parties. There may be economies of scale in managing risk through reinsurance that may make it attractive to use reinsurance to consolidate the risks of an affiliated group in one entity, before subsequently shifting the risk to third parties or managing risk within the group. For example, risks that may partially or fully offset each other may serve to minimize volatility when the

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[664] Life insurers' reserves are calculated using specified interest rate assumptions (sec. 807), and discounting rules applicable to tax reserves of property and casualty insurance companies partially take account of the time value of money (sec. 846).

[665] A primary insurer can use reinsurance to reduce exposure to extremely large losses from one source such as a catastrophic event (for example, a hurricane) or a particular environmental hazard (for example, asbestos). By reinsuring amounts above a certain level, the primary insurer can smooth loss payments over the year or between years. This can reduce volatility in the company's earnings.

[666] State insurance rules generally require that an insurance company maintain surplus, and the States limit the amount of new business the company can write based on a ratio of net premiums to surplus. Reinsuring some of the company's risks can lower the ratio of net premiums to surplus and allow the company to write more insurance. Thus, reinsurance can serve in effect as a form of financing for growth in the primary insurance company's business. The amount of net premiums for this purpose is determined net of premiums ceded to a reinsurer. Under State regulation, a ceding company treats amounts due from reinsurers as assets or reductions of liability, an accounting practice known as credit for reinsurance. See Joseph Sieverling and Scott Williamson, "The U.S. Reinsurance Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004), p. 126.

[667] By reinsuring a block of business, for example, a reinsurer can enter a new line of business more easily than by directly writing policies in that line of business. Similarly, a primary insurer can divest itself of a line of business by reinsuring its entire book of business in that line. See Donald A. McIsaac and David F. Babbel, "The World Bank Primer on Reinsurance," *Policy Research Working Paper 1512*, The World Bank (1995).

offsetting risk pools are centralized in one entity rather than being dispersed in separate affiliated entities. Affiliated groups may also experience transaction cost savings in financing risks.[668]

Tax benefits may also provide a reason for reinsurance transactions, including reinsurance transactions with affiliates. In general, premiums ceded for reinsurance are deductible in determining a company's Federal income tax.[669] Present law does not disallow this deduction if the affiliate to which the risks are ceded does not pay U.S. income tax on associated earnings. Thus, it is possible that a reinsurance transaction can be viewed as an earnings stripping transaction in some circumstances. Arguably, the earnings stripping concern arises if the reinsurer is an affiliate of the ceding company, and the parent of the affiliated group is not a U.S. corporation. In the reinsurance transaction, risks may be ceded to the foreign reinsurer, and along with the risks, earnings on the reserves relating to the ceded risks are shifted to the foreign reinsurer. In this circumstance, U.S. tax is not paid on the earnings on the reserves that are shifted overseas, even though these earnings remain within the affiliated group. Similarly, underwriting profits (if any) of the U.S. insurer with respect to the reinsured risk may be shifted overseas through reinsurance with a foreign affiliate. This type of transaction has been criticized as tax-motivated.[670]

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[668] For example, when risks are centralized within an affiliated group, transaction costs of financing those risks may be reduced by issuing larger and fewer tranches of cat bonds. Catastrophe ("cat") bonds are an alternative risk transfer mechanism involving capital markets financing. See Karen Eeuwens, "Convergence Quarterly: Cat Bonds to Get Q4 Boost," Reactionsnet.com, 27 (November 2009); Peter A. Gentile, Spencer M. Gluck, Peter Senak, and Jeffrey M. Stewart, Modern ART Practice, Gerling Global Financial Products (2000); Thomas Holzheu, "Alternative Risk Transfer (ART) Products," in Reinsurance: Fundamentals and New Challenges (ed. Ruth Gastel), Insurance Information Institute (2004), 113-124; "The Picture of ART," Sigma, Swiss Reinsurance Company Economic Research and Consulting (2003).

[669] Secs. 805(a)(6), 832(b)(4).

[670] See Jon Almeras and Ryan J. Donmoyer, "Insurers Approach Congress to Fix 'Bermuda Loophole,'" 86 *Tax Notes* 1660 (March 20, 2000); Lee A. Sheppard, "News Analysis – Would Imputed Income Prevent Escape to Bermuda?," 86 *Tax Notes* 1663 (March 20, 2000). And see Hearing of the Senate Committee on Finance, "Offshore Tax Issues: Reinsurance and Hedge Funds," September 26, 2007, Testimony of William R. Berkley, Chairman and CEO, W.R. Berkley Corporation: "Current law allows a U.S. member of a foreign–domiciled group to avoid paying U.S. tax on much of its domestic underwriting and investment income, merely by reinsuring its business with a related-party reinsurer domiciled in a country such as Bermuda or the Cayman Islands. By contrast, a U.S.-based insurance group must pay U.S. tax on all of its underwriting and investment income derived from writing similar domestic business." http://finance.senate.gov/sitepages/hearing092607.htm. See also Susanne Sclafane, "U.S. CEO on a Mission to Tax Bermuda Competitors," *National Underwriter Online News Service*, Nov. 20, 2006; Susanne Sclafane, "Bermuda CEO Fights Back on Tax Issue," *National Underwriter Online News Service* (November 21, 2006). In 2002, in oral testimony before the Ways and Means Committee and in written response to a question, Pamela Olson, Acting Assistant Treasury Secretary for Tax Policy, stated, "The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S. -source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transaction [sic] are not sufficient to address this situation." Hearing of the House Committee on Ways and Means on Corporate Inversions, June 6, 2002, Serial 107-73, pages 9-10 and 26, http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/6-6-02/107-73final.htm.

Technical aspects of the operation of the proposal

Deduction deferral

The proposal generally has the effect of deferring, rather than permanently denying, the deduction for the reinsurance premium paid. The proposal achieves the result of deduction deferral because it provides for an exclusion from income for reinsurance recovered (and for ceding commissions) with respect to reinsurance for which the premium deduction has been denied. That is, the exclusion of the amount of reinsurance recovered when the insured event occurs offsets the earlier deduction denial. The economic effect is that the deduction is deferred until the receipt of the corresponding excludable amount, rather than being permanently disallowed.

It could be argued that merely deferring the deduction for reinsurance premiums does not adequately address the tax policy problem of avoidance of U.S. tax on investment earnings on the premiums shifted offshore. The mere deferral of the deduction for affiliate reinsurance premiums cannot deter affiliated reinsurance transactions, it could be said. In this respect, critics may assert that the proposal could prove ineffectual.

On the other hand, though the proposal may not deter affiliated reinsurance transactions, it may serve to measure the ceding company's income more accurately than either allowing a current deduction, or denying the deduction permanently. Under this view, the proposal is targeted to the problem of avoidance of U.S. tax on investment income shifted offshore. The proposal achieves this targeting because the period of deduction deferral is coordinated with the period of investment income tax avoidance. Under the proposal, the deduction is deferred until time that a recovery of reinsurance (if any) is received and is excluded from the taxpayer's income.

This aspect of the proposal has the effect that the deferral of the deduction is longer for long-tail lines of business than for short-tail lines of business. Generally, the time between the payment of the reinsurance premium and the receipt of amounts of reinsurance recoverable is longer for long-tail than for short-tail lines of business. Though the proposal does not explicitly distinguish between long-tail and short-tail lines of business, the period of deferral of the deduction for the reinsurance premium paid is dependent on this distinction. Linking the period of deduction deferral to the period before which amounts of reinsurance (if any) are recovered can be viewed as roughly correlating the deduction deferral period to the investment income tax avoidance period, arguably a rational tax policy response.[671]

A possible concern in this regard involves the fact that the exclusion applies not only to reinsurance recoverable, but also to ceding commissions. Ceding commissions may be paid at

[671] The proposal does not take account of the possibility of differing tax rates at the time of the deduction disallowance and at the later time of the exclusion of reinsurance recoverable. For example, if the taxpayer's marginal U.S. tax rate were 35 percent at the time the deduction is disallowed, but is 30 percent at the time of the exclusion, the tax detriment of the disallowance is greater than the tax benefit of the exclusion; and conversely, if the tax rate is 40 percent at the time of the exclusion, then the tax detriment of the deduction disallowance is less than the tax benefit of the income exclusion.

the time of the initial reinsurance transaction rather than at the later time when reinsurance recoverable is determined. Thus, some portion of the reinsurance premium deduction may not be deferred to the extent the excluded ceding commission is received up front. A related concern involves the amount of the ceding commission. If the amount of the ceding commission reflects more than transaction costs, and in fact includes amounts attributable to anticipated reinsurance recoverable, the deduction deferral period may not correlate to the investment income tax deferral period. This concern arguably could be addressed, however, by anti-avoidance rules.

First dollar approach

The proposal takes a first dollar approach, in that the first dollar of deduction is disallowed in the case of any amount of premiums for reinsurance coverage paid to a foreign affiliate. This approach could be criticized as failing to take into account reasons other than tax motivation to engage in affiliate reinsurance transactions, such as a purpose to shift capital to a central jurisdiction where it can be mobilized to locations in the world where insured events occur. No amount of affiliate reinsurance is assumed to be entered into for reasons other than U.S. tax consequences, under the first dollar approach taken by the proposal.

On the other hand, though the proposal does not contemplate non-tax-motivated affiliate reinsurance, the consequence of triggering the proposal's sanction is a deferral, rather than a denial, of the deduction for the reinsurance premium. The impact of the proposal is largely one of timing of the deduction for reinsurance premiums paid. Arguably, the proposal directly addresses the shifting of investment earnings offshore by denying the tax benefit of the deduction for the period that the premium is moved offshore.

A related point is that some portion of reinsurance is not tax motivated, so the deduction for affiliate reinsurance premiums for this portion of risks reinsured should not be disallowed. To ascertain what portion should not be disallowed, a percentage based on average industry-wide third party reinsurance could be devised on a line-of-business basis, and only the excess over this amount should be disallowed. Arguably, the failure of the proposal to relate the disallowance to industry norms for reinsurance prevents the proposal from accurately distinguishing between reinsurance that is likely to be motivated by U.S. tax avoidance, and reinsurance that is typical and could be motivated by business, regulatory, or other nontax considerations.

On the other hand, allowing a deduction for a portion of affiliate reinsurance is not necessary or appropriate under the proposal, because the proposal provides an offsetting exclusion for reinsurance recovered. Thus, the proposal already properly accounts for avoided U.S. income tax on the investment income shifted offshore. The proposal accomplishes this result by deferring the entire deduction for premiums for affiliate reinsurance, but only for the period during which related investment income escapes U.S. tax -- that is, the period between the payment of the claim and the receipt of reinsurance recoverable.

Proportional exclusion of ceding commissions and reinsurance recoverable

The proposal provides for an exclusion from income for only that part of the ceding commissions received and reinsurance recoverable that is proportionate to the part of the premium deduction that was denied. The meaning of this proportionality rule is not clear under a

first dollar approach to deduction denial, which denies the deduction for the entire premium for affiliate reinsurance. Thus, the proportion is always 100 percent.

On the other hand, the proportionality concept may reflect the possibility that only a part of a reinsurance premium could be nondeductible under the proposal. This could occur if some, but not all, of the shareholders of the affiliate to which it is paid are U.S. shareholders that are currently taxed under Subpart F on a portion of the premium. Arguably, a rule providing that the exclusions may not exceed the nondeductible amount of the reinsurance premium paid could address this point.

There may be a concern that the cost of coverage could be disproportionately large (or small) compared to the amount of the premium, and that this underwriting pricing discrepancy should not affect the tax result under the proposal. A premium pricing discrepancy could occur once the insured event occurs, if it turns out that the insured event it is much more (or less) costly than was anticipated when the premium was set. Perhaps the proposal is not intended to take such pricing discrepancies into account in determining the amount of reinsurance recovered that may be excluded. That is, the proposal may be intended to take into account investment earnings, but not underwriting profit or loss, in determining the amount of the deduction that is deferred. The proportional exclusion approach of the proposal, however, arguably is unsuccessful. Other possible approaches to distinguishing between investment return, and underwriting return, might involve assuming an average investment return on affiliate reinsurance premiums paid, or taking account of the taxpayer's actual or historic rate of return on investments. An alternative interpretation of the exclusions is to assume that they are permitted only to the extent that the amount of the associated premium that was nondeductible under the proposal. That is, rather than being proportionate to the deduction disallowance, the exclusions are capped by the amount of the related deduction disallowance.

Other issues

Nondiscrimination

The proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. Nondiscrimination articles of U.S. tax treaties generally prohibit nationals of one treaty country from being subjected to more burdensome taxation (or any connected requirement) in the other treaty country than are nationals of that other treaty country in the same circumstances. It is believed that the proposal does not violate any nondiscrimination article of any applicable U.S. tax treaty.

Some may argue that the proposal violates these treaty requirements by denying deductions to U.S. affiliates of foreign companies when they reinsure with their foreign affiliates, but not applying a comparable deduction disallowance rule to U.S. companies reinsuring with their U.S. affiliates. Others may respond that the proposal does not violate any nondiscrimination article of any applicable U.S. tax treaty because the proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. By making this election, any

foreign reinsurance company can insure that it is treated at least as well as any U.S. insurance company.

In addition, U.S. tax treaties generally provide that the nondiscrimination article does not apply in certain cases involving transactions between related persons. One of these circumstances arises in cases in which paragraph 1 of Article 9 (Associated Enterprises) of a U.S. tax treaty applies. That paragraph applies in cases in which an enterprise of a treaty country is related to an enterprise of the other treaty country, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship.[672]

Inconsistent treatment for ECI election and foreign tax credit

The proposal provides an election to treat affiliated reinsurance as effectively connected with a U.S. trade or business, yet the proposal also allows a foreign tax credit with respect to the reinsurance income as if it were foreign source income. Treating the income as U.S. effectively connected income, at the same time as a foreign tax credit is allowed, gives rise to a potential inconsistency that could cause confusion, create difficulty in tax administration for the taxpayer and the government, and present opportunities for manipulation and tax avoidance. On the other hand, if the purpose of the election is to achieve nondiscriminatory treatment, then relief of foreign taxation of income that is also subject to U.S. taxation under the election may be consistent with that purpose. Arguably, the prohibition of cross-crediting achieved by creating a separate category or "basket" for this income for foreign tax credit limitation purposes tends to reduce the potential for tax abuse.

Transfer pricing issues

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Within a controlled group, there are no market pressures that impose market pricing on transactions between related parties. The lack of an identifiable market price provides opportunities for companies to shift income among group members through controlled transactions at off-market prices.

To preserve the U.S. tax base, section 845 authorizes the Secretary of the Treasury to (1) allocate between or among two or more related persons (within the meaning of section 482) who

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[672] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 24, par. 4; Art. 9, par. 1. On a related issue, under principles relating to trade rather than purely to tax policy, it is argued that the proposal may violate Article XVII of the World Trade Organization General Agreement on Trade in Services (GATS), relating to national treatment. See Gary Clyde Hufbauer, "Protection by Stealth: Using the Tax Law to Discriminate against Foreign Insurance Companies," *Peterson Institute for International Economics* Policy Brief No. PB810-9, April, 2010. On the other hand, it may be argued that the proposal does not violate the GATS national treatment Article because, for example, the proposal is (1) a direct tax measure, and (2) based on objective criteria regarding the deductibility of payments that erode the U.S. tax base. Trade issues are beyond the purview of this analysis.

are parties to a reinsurance agreement items of income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items; (2) recharacterize any such items; or (3) make any other adjustment to reflect the proper amount, source, or character of the taxable income (or any item described in (1) relating to such taxable income) of each person. Section 845 generally does not prescribe any specific reallocation rules. Rather, it is designed to prevent tax evasion and preserve clear reflection of income. Treasury regulations under section 482 adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

The premium and ceding commission on reinsurance may be analogous to a transfer price for the underlying insurance risk. Following this analogy, a concern about affiliate reinsurance may be viewed as a concern about the transfer price. Opponents of the proposal may argue that Treasury authority under section 845, along with the presence of comparable third-party reinsurance transactions, is sufficient to combat any abuse in this area.

However, one of the purposes of affiliate reinsurance is to mitigate the effect of asymmetric information on increasing the price charged for reinsurance risk. That is, a third party may need to charge a higher premium to compensate itself for the uncertainty regarding the true nature of the risk being transferred.[673] This asymmetry suggests that third-party reinsurance may be an imperfect standard by which to judge the appropriateness of the transfer price for the insurance risk. To the extent that the third-party reinsurance premium is too high (or the ceding commission is too low) as a standard of comparison, it would lead to an understatement of income for the ceding company and an overstatement of income for the assuming company in the case of affiliated reinsurance.

A transfer pricing concern is also raised in statements in the legislative history of the 2004 amendment to section 845(a) with respect growth of offshore affiliate reinsurance.[674] If this analysis is accurate, the IRS may be able to apply section 845 in a particular case to reallocate income and deductions between such related parties on the basis of the argument that an unrelated party would not have reinsured such a large proportion of its U.S. risks. However, the IRS might be unsuccessful in challenging the questioned transactions. Further, it is difficult to obtain consistent results on a case by case basis applying transfer pricing concepts.

Prior Action

A similar proposal was included in the President's fiscal year 2001 budget proposal.

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[673] Michael Cragg, J. David Cummins, and Bin Zhou, *The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis*, The Brattle Group (July 8, 2010), 11.

[674] Senate Finance Committee Report to S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. 108-192, November 7, 2003, 161, relating to section 845 of the Code.

6. Limit earnings stripping by expatriated entities

Present Law

A domestic corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[675] Generating excessively large U.S. tax deductions in this manner is known as "earnings stripping." Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax may be reduced or eliminated under an applicable income tax treaty.

Although the term "earnings stripping" may be broadly applied to the generation of excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions.[676] In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Earnings stripping limitations

Present law limits the ability of foreign corporations to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through earnings stripping transactions. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by the payor in a taxable year is generally disallowed to the extent that the payor's "net interest expense" (i.e., the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion).[677] Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such

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[675] It is also possible for U.S.-controlled corporations to reduce their U.S. taxable income by making excessive deductible payments to foreign corporations that they control. In general, however, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

[676] Herein, except when noted otherwise, "earnings stripping" refers to the generation of excessive interest deductions.

[677] Sec. 163(j).

interest;[678] or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Corporate inversion transactions

The United States employs a "worldwide" tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Foreign corporations are taxed by the United States only on income that has sufficient nexus to the United States. As a consequence, the U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. Tax rates vary by country, and not all countries choose a worldwide system of income taxation. Thus, depending upon its particular circumstances, a multinational group may be able to increase the after-tax returns to its investments by locating its parent corporation outside the United States.

For purposes of U.S. tax law, a corporation is treated as domestic if it is created or organized in the United States or under the laws of the United States or of any State.[679] All other corporations are generally treated as foreign.[680] Thus, the place of creation or organization determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's shareholders.

Until recently, some U.S. multinational groups sought to take advantage of the differential treatment of U.S. and foreign domiciled top-tier companies through transactions commonly referred to as "inversions." A domestic parent corporation could reincorporate in a foreign jurisdiction, potentially without any exit tax to compensate the United States for the loss of future tax revenue from the departing company. Under prior law, these inversion transactions could produce a variety of tax benefits, including the removal of a group's foreign operations from U.S. tax jurisdiction and, as discussed further below, the potential for reduction of U.S. tax on U.S.-source income through subsequent "earnings stripping" transactions (e.g., large payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent). It

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[678] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

[679] Sec. 7701(a)(4).

[680] Sec. 7701(a)(5).

was not always clear, however, whether these inversions had a significant nontax purpose or effect, or whether the corporate group had a significant business presence in the new country of incorporation.

The American Jobs Creation Act of 2004 ("AJCA") included provisions designed to curtail inversion transactions.[681] Most significantly, AJCA added section 7874 to the Code. That section defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. In an inversion transaction, a domestic parent company is replaced with a foreign parent. The first type of inversion is a transaction in which (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003;[682] (2) the former shareholders of the domestic corporation hold (by reason of holding stock in the domestic corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Section 7874 denies the intended tax benefits of this type of inversion ("80-percent inversion") by deeming the top-tier foreign corporation to be a domestic corporation for all tax purposes, notwithstanding any other provision of the Code or a tax treaty.

The second type of inversion is a transaction that would meet the definition of an 80-percent inversion, except that the 80-percent ownership threshold is not met. In such a case, if a 60-percent ownership threshold is met, then a second set of rules applies to the inversion ("60-percent inversion"). Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure cannot generally be offset by tax attributes such as net operating losses. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of stock or the transfer or license of other assets by the domestic corporation (or a U.S. person related to the domestic corporation) as part of the inversion transaction or after such transaction to a related foreign person generally cannot be offset by tax attributes (e.g., net operating losses). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.[683]

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[681] Pub. L. No. 108-357, sec. 801(a) (2004).

[682] A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

[683] Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership if, after the acquisition, at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met.

In both types of inversions, the domestic corporation (or partnership) that becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003, or any U.S. person related to such a domestic corporation (or partnership), is referred to as an "expatriated entity."[684]

Description of Proposal

The proposal tightens the earnings stripping deduction limitations as applied to expatriated entities. Under the proposal, expatriated entities may not utilize the 1.5-to-1 debt-to-equity ratio safe harbor. In addition, the 50-percent of adjusted taxable income threshold for the limitation is reduced to 25 percent. The carryforward for disallowed interest is limited to 10 years and the carryforward of excess limitation is eliminated.

An expatriated entity is defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989.[685] This special rule does not apply, however, in the case of an 80-percent inversion in which the top-tier foreign corporation is treated as a domestic corporation for all tax purposes under section 7874.

Effective date.–The proposal is effective for interest paid or accrued in taxable years beginning after December 31, 2011.

Analysis

The number of corporate inversion transactions prior to the enactment of section 7874 led some, including the Treasury Department, to question the efficacy of the present-law earnings stripping rules.[686] In the case of some prominent, pre-AJCA corporate inversions, it appeared that the earnings stripping benefit achieved when a U.S. subsidiary paid deductible amounts to its new foreign parent or other foreign affiliates constituted the primary intended tax benefit of the inversion transaction, which should not have been the case if the earnings stripping rules had

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[684] Sec. 7874(a)(2).

[685] This rule aligns the applicability of the inversion rules with the effective date of the original earnings stripping provision. The earnings stripping rules (section 163(j)) are generally applicable to instruments issued after July 10, 1989, with a grandfather rule for acquisitions made (or subject to a binding contract) on or before July 10, 1989.

[686] See, e.g., U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, p. 104 (2003) ("Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Office of Tax Policy, U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002) ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited.").

been functioning properly.[687] Thus, AJCA required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the provisions of the Code applicable to earnings stripping.[688] The report, which was submitted to Congress on November 28, 2007,[689] is discussed in more detail below.[690]

In summary, however, the 2007 Treasury report concludes that "[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[691] In reaching this conclusion, the report largely relies on an outside study of 12 inverted corporations[692] and a supplemental Treasury Department analysis of payments declared on Form 5472.[693] The Treasury earnings stripping

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[687] See, e.g., Office of Tax Policy, U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002); Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, pp. 3-4.

[688] Pub. L. No. 108-357, sec. 424 (2004). The report also includes AJCA-mandated studies on transfer pricing and U.S. income tax treaties. Pub. L. No. 108-357, sec. 806(a), (b) (2004).

[689] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007) (hereinafter 2007 Treasury report). Throughout the remainder of this part, "Treasury earnings stripping report" is used to refer to chapter II of this 2007 Treasury report, which specifically addresses earnings stripping, while "Treasury income tax treaty report" is used to refer to chapter IV of this 2007 Treasury report, which specifically addresses U.S. income tax treaties.

[690] Subsequent to the issuance of its Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, the Treasury Department's Office of Tax Analysis issued a paper that focuses solely on earnings stripping using the same 2004 dataset. The report reaches some of the same general conclusions as the Report with respect to its comparison of foreign-controlled domestic corporations to domestic-controlled corporations. Harry Grubert, "Debt and the Profitability of Foreign-Controlled Domestic Corporations in the United States," OTA Technical Working Paper 1 (2008).

[691] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26.

[692] Jim A. Seida and William F. Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion," *National Tax Journal* 57 (2004): 805-28 (hereafter, Seide and Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion"). Seide and Wempe found that the 12 inverted corporations had a significantly larger increase in foreign income and a significantly larger decrease in U.S. profit margin and effective tax rate than a control group of corporations. Seide and Wempe also more closely examined four inverted corporations for which detailed information on the levels of intercompany debt and interest and fee expense were readily available, and found that these levels increased significantly post-inversion. Moreover, for three of those four corporations, information could be determined regarding the geographic location of these attributes, and with respect to those three, most of the long-term debt, interest, and fee expense was attributable to the U.S. operations. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), pp. 21-22.

[693] Form 5472 is an information return of (1) a U.S. corporation owned 25 percent or more by one foreign person, or (2) a foreign corporation engaged in a trade or business within the United States. Such reporting is required under sections 6038A and 6038C. Form 5472 includes information on cross-border payments, including fees, interest, and royalties, between the reporting corporation and foreign-related persons.

report also concludes, however, that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[694] and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[695] Consistent with those conclusions, the proposal would change the earnings stripping rules for expatriated entities only. By eliminating the debt-equity safe harbor,[696] reducing the adjusted taxable income threshold from 50 percent to 25 percent for interest on related-party debt, limiting the carryforward of disallowed interest to 10 years, and eliminating the carryforward of excess limitation, the proposal significantly strengthens rules that appear ineffective in preventing certain recent earnings stripping arrangements in the context of corporate inversion transactions.[697]

Earnings stripping by foreign-controlled domestic corporations–the conclusions of the Treasury report

The Treasury earnings stripping report presents three separate analyses using tax data to test whether foreign-controlled domestic corporations are engaging in earnings stripping outside the context of inversion transactions. First, the report examines the relative profitability of foreign-controlled domestic corporations and domestic-controlled corporations by comparing the ratios of net income to total receipts, concluding that foreign-controlled domestic corporations are generally less profitable than their domestic-controlled counterparts.[698]

Second, the Treasury earnings stripping report compares the ratios of "operating income" to total receipts for foreign-controlled domestic corporations to the corresponding ratios for domestic-controlled corporations. Operating income is defined as net income plus interest expense, depreciation, and similar items, and minus interest income, dividends, and royalties received. The report finds that, after adjusting for these items, foreign-controlled domestic

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[694] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 25.

[695] *Ibid*., p. 26.

[696] The Treasury earnings stripping report notes that all of the four more closely examined inverted corporations in the study by Seide and Wempe appear to be within the 1.5 to 1 debt-to-equity safe harbor. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 23; see also Seide and Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion," p. 821.

[697] The 2007 Treasury report acknowledges that section 806 of AJCA requires the Treasury Department to conduct a study of the effectiveness of the provisions of AJCA relating to corporate expatriation, including the formulation of recommendations on improving the effectiveness of those provisions. The Treasury Department intends to separately issue to the Congress the report on that study. Nonetheless, the 2007 Treasury report states that "section 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 3.

[698] *Ibid*., p. 13. These analyses were separately performed for the nonfinancial and financial sectors. In addition, a separate analysis was done for the manufacturing industry, which is a component of the nonfinancial sector.

corporations are generally more profitable than their domestic-controlled counterparts.[699] The data in this part of the study show that domestic-controlled corporations have greater interest expense as a proportion of total receipts than do foreign-controlled domestic corporations.[700]

It is unclear whether these findings with respect to profitability tend to support or refute the proposition that foreign-controlled domestic corporations engage in earnings stripping. Some might argue that even if the findings with respect to operating income suggest that foreign-controlled domestic corporations in the nonfinancial and, more specifically, the manufacturing sectors are more profitable than comparable domestic-controlled corporations before interest income and expense (and other non-operating items) are taken into account, the data presented do not identify how much of the interest income is received from, and interest expense is paid to, foreign-related parties, and, therefore, it is difficult to conclude that foreign-controlled domestic corporations are engaging in earnings stripping rather than utilizing third-party debt.[701]

Third, the Treasury earnings stripping report analyzes the relationship between interest expense and cash flow.[702] The report determines that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestic-controlled corporations.

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[699] *Ibid.*, pp. 15-16. These analyses were separately performed for the nonfinancial and manufacturing sectors. The Treasury earnings stripping report's measure of operating income is reduced by non-interest expenses, such as research and experimentation, stewardship, and State and local taxes, which the taxpayer must allocate or apportion to foreign-source income for foreign tax credit purposes. Because by definition the foreign-source income associated with these expenses is generally excluded from operating income, adding back such expenses may provide the basis for a more valid comparison between foreign-controlled domestic corporations and domestic-controlled corporations.

[700] See *ibid.*, p. 15, table 2.2. This data, particularly the ratio of interest paid to total receipts, may suggest that foreign-controlled domestic corporations are not engaged in earnings stripping. However, it should be noted that it would be possible for a domestic-controlled corporation and a foreign-controlled domestic corporation to have similar interest expense burdens but have dissimilar reasons underlying their equivalent burdens. For example, a domestic-controlled corporation is more likely than a foreign-controlled domestic corporation to incur significant interest expense in the United States that may be linked (or, in technical terms of the Code, allocable or apportionable) to foreign-source income (and such income may be currently includible in U.S. taxable income or deferred), reflecting that foreign-controlled domestic corporations are more likely to incur interest expense solely for the purpose of financing economic activity conducted in the United States, while domestic-controlled corporations often incur interest expense in connection with the financing of both domestic and foreign entities in the overall corporate group. The same data issue may exist with respect to the interest expense and cash flow analysis set forth in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 18.

[701] Unfortunately, the Treasury earnings stripping report does not analyze the data from Form 5472 regarding interest payments from foreign-controlled domestic corporations to their foreign owners (i.e., disqualified interest). That analysis might have shed some light on the extent of any earnings stripping.

[702] The numerator, interest paid, used by the Treasury Department in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 18, takes into account interest expense linked to deferred income (both foreign- and domestic-source income), while neither cash flow nor total receipts, the alternative denominators, reflects this deferral. This asymmetry may affect the comparison of results for foreign-controlled domestic corporations and domestic-controlled corporations.

The report also determines that foreign-controlled domestic corporations in these sectors are less likely to be above the section 163(j) threshold of 50 percent of adjusted taxable income than are comparable domestic-controlled corporations.[703] In the financial sector, the report determines that foreign-controlled domestic corporations in some industries appear to have significantly higher interest expense relative to cash flow than their domestic-controlled counterparts. However, the Treasury earnings stripping report states that "the comparison is not completely unambiguous and it is difficult to draw firm conclusions from the data because of the possibility of alternative explanations and the problems with using domestic-controlled corporations as a comparison group."[704]

Thus, the Treasury earnings stripping report concludes that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[705] and that it is not possible to determine with precision whether section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.[706] The Treasury Department recommends gathering additional information from taxpayers relating to earnings stripping to determine whether it would be appropriate to modify the proposal with respect to foreign-controlled domestic corporations. Accordingly, on November 28, 2007, the Treasury Department and the IRS issued a proposed tax form, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*, to gather additional information from corporate taxpayers relating to the determinations and computations under section 163(j).[707] In December 2008, Form 8926 was issued in final form.

Discussion of wider points raised by Treasury earnings stripping report

Effects of debt financing

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through equity or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing—for example, debt financing may allow a business to raise funds at a lower cost (for example, the return to investors may be lower because debt is a less risky investment than an equity investment in the same business) and without surrendering ownership. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing, even if not rising to the level of earnings stripping, may facilitate lowering the aggregate burden of U.S. tax on the U.S. operations, thereby lowering the foreign parent corporation's overall tax rate on its worldwide operations. Moreover, even if the full 30-percent U.S. withholding tax is

[703] *Ibid.*, p. 19.

[704] *Ibid.*, p. 21.

[705] *Ibid.*, p. 25.

[706] *Ibid.*, p. 26.

[707] See Announcement 2007-114, 2007-2 C.B. 1176.

imposed upon the interest payment, there remains a five-percent taxpayer-favorable difference, if the interest expense is deductible at the highest U.S. corporate rate of 35 percent. In addition, the interest recipient may be able to take a credit for the U.S. withholding tax, in whole or in part, against its tax in the applicable foreign country, or the interest may be tax-exempt in such country. Although a foreign tax credit might also be available for withheld taxes on a dividend and the underlying U.S. corporate tax, in general there is a greater possibility of double taxation in the case of dividends paid by foreign-controlled domestic corporations to their parents than in the case of interest. Moreover, debt principal may be repaid on a tax-free basis, while redemption of equity by a foreign parent is generally treated as a dividend distribution unless the corporation paying the dividend has no earnings and profits.[708]

Studies have determined that, with some exceptions, greater investment is linked to overall higher labor compensation.[709] The Treasury earnings stripping report suggests that income shifting may support increased investment into high-tax jurisdictions (such as the United States) by lowering the effective tax rate.[710] Whether the ability of U.S. businesses to pay interest to related foreign debt-holders should be further abated may be part of a larger policy discussion that balances revenue and other needs in an international context.[711] It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. However, the best way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as the facilitation of earnings stripping.

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[708] See secs. 301, 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. See sec. 302(b).

[709] Recent references to this linkage include David L. Brumbaugh, Congressional Research Service, *Tax Treaty Legislation in the 110th Congress: Explanation and Economic Analysis* (CRS Report RL34245) (2008), p. 8.

[710] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 24. Existing empirical research does not address this question. *Ibid*. The linkage between foreign investment and labor compensation requires that a number of things be held constant–for example, that any potential loss of revenue associated with income shifting not also "crowd out" investment in the United States by either domestic or foreign investors.

[711] Notwithstanding that the two issues have historically been analyzed separately, a recent paper suggests that the determination of allowable interest deductions in the inbound and outbound contexts be coordinated through a multilateral agreement under which each country would allocate interest deductions to assets on a uniform worldwide basis and allow a proportionate amount of interest expense to be deducted against income earned domestically, without regard to where the borrowing occurs. The effect of such a system would be to deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world. Michael Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," IBFD, 62 *Bulletin for International Taxation* (November 2008), p. 486.

Earnings stripping and tax treaties

Earnings stripping generally provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or a special tax regime for financing structures, and if that country has entered into a tax treaty with the United States that provides a reduced U.S. withholding tax rate on interest.

Thus, the applicable foreign tax rate and the U.S. withholding tax rate on the interest payment are two factors that affect the ability of foreign-controlled domestic corporations to effectively engage in earnings stripping. These two factors are interrelated. While a low foreign tax rate relative to the U.S. rate is critical to effective earnings stripping, if the general foreign tax rate is zero, it is not likely that the United States would now enter into a tax treaty with that foreign country that lowers the U.S. withholding tax rate on interest. Therefore, such a foreign corporation may attempt to utilize a U.S. tax treaty with another foreign country to obtain a lower U.S. withholding tax rate. This practice is known as treaty shopping.[712]

As described in detail in the Treasury income tax treaty report issued with the Treasury earnings stripping report, the Treasury Department has taken significant steps since 2000 to combat treaty shopping by negotiating new and stricter limitation-on-benefit ("LOB") provisions with several U.S. treaty partners, as well as including a similar new LOB provision in the United States Model Income Tax Convention of November 15, 2006. These stricter LOB provisions include a series of complex objective tests to determine whether a resident of a treaty country is sufficiently connected economically to that country to warrant receiving treaty benefits.[713]

Limitation of the scope of the proposal to expatriated entities

As discussed elsewhere in this document, certain of the Administration's other proposals may reduce somewhat the incentive that may exist under present law for certain U.S. persons to make investments outside of the United States, instead of within the United States, because of the more favorable U.S. tax treatment available for such foreign investments.[714] The same proposals may make corporate structures with a domestic parent relatively less attractive than corporate structures with a foreign parent because those proposals are more likely to raise the

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[712] Treaty shopping is not limited to withholding on interest payments. A person may engage in treaty shopping to obtain other benefits under a U.S. tax treaty, for example, to lower withholding on royalty or dividend payments, or to exempt income from a U.S. trade or business that is not attributable to a permanent establishment in the United States.

[713] See U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), pp. 78-82.

[714] See, for example, the analysis of the Administration's proposals to defer deduction of interest expense related to deferred income (Part V.C.1) and to determine the foreign tax credit on a pooling basis (Part V.C.2).

U.S. tax liability for the domestic parent structure than for the foreign parent structure. This proposal may counteract some of the U.S. tax advantage perceived to exist for foreign parent structures vis-à-vis domestic parent structures by significantly reducing opportunities for certain foreign parent structures (specifically, those involving domestic parent structures that inverted) to reduce their U.S. tax liability by engaging in earnings stripping using deductible interest. However, the effectiveness of this counterbalancing may be limited due to the fact that the proposal applies only to certain expatriated entities and not to, for example, newly established foreign-controlled domestic corporations.

Section 7874 appears to have significantly reduced the opportunity for domestic-controlled corporations to engage in earnings stripping by engaging in new inversion transactions.[715] However, both incentive and opportunity remain for foreign-controlled domestic corporations (including new enterprises that opt out of U.S. residence for their top-tier entities), corporations that engage in 60-percent inversions, and corporations that inverted on or before March 4, 2003, to engage in earnings stripping. The proposal would further restrict earnings stripping for corporations that engage in 60-percent inversions and the pre-March 3, 2003 inverters,[716] but not for the much larger group of foreign-controlled domestic corporations that have not inverted.

Although recent legislative and treaty developments have removed some significant opportunities for earnings stripping, and notwithstanding that the Treasury earnings stripping report does not conclusively determine that foreign-controlled domestic corporations that are not expatriated entities are engaging in earnings stripping, some argue that, as a matter of tax policy, the earnings stripping rules should treat foreign-controlled domestic corporations in the same manner as expatriated entities because both types of corporations have the same incentives and

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[715] The 2007 Treasury report states, "[s]ection 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 3. However, the IRS and Treasury Department have since issued temporary and proposed regulations addressing the application of section 7874 in certain circumstances. T.D. 9453, 74 Fed. Reg. 27,920 (June 12, 2009) (temporary regulations); 74 Fed. Reg. 27,947 (June 12, 2009) (proposed regulations). The preamble to the temporary regulations states that the IRS and Treasury Department have become aware of certain transactions that are intended to avoid section 7874, but that they believe present the same policy concerns that prompted the enactment of section 7874. Thus, the temporary and proposed regulations clarify that such transactions are still within the scope of section 7874. In particular, the temporary and proposed regulations address transactions that utilize multiple foreign corporations to make acquisitions of substantially all of the properties held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership, transactions involving one foreign corporation acquiring substantially all of the properties of multiple domestic corporations or partnerships, and transactions involving an insolvent domestic corporation in which the creditors of the corporation claim not to be shareholders. In addition, in September 2009, the IRS issued a notice providing guidance on additional transactions involving a transfer of cash (or certain other assets) to a foreign corporation to limit the application of section 7874. Notice 2009-78, 2009-2 C.B. 452. The notice also indicated that the IRS and the Treasury Department intend to issue further regulations under section 7874 addressing these and other transactions.

[716] Some might argue that it is unfair to impose an additional tax burden on corporations on the basis of transactions occurring in part prior to the time the transactions were addressed by the Code. However, the proposal would be effective only with respect to interest paid or accrued in taxable years beginning after December 31, 2011. Therefore, it is not retroactive in effect.

capabilities to erode the U.S. tax base, and may do so in the same manner. Proponents of this argument observe that it should not be surprising that the available information clearly demonstrates that expatriated entities are engaging in earnings stripping because expatriated entities comprise an easily-identifiable subclass of foreign-controlled domestic corporations and have demonstrated a propensity for aggressive tax planning. Proponents of stricter across-the-board earnings stripping rules also argue that there is sufficient evidence of earnings stripping to justify implementing such a regime, and that significant erosion of the U.S. tax base will continue until the earnings stripping rules are strengthened for all foreign-controlled domestic corporations.

Others agree with the conclusion of the Treasury earnings stripping report that there is insufficient evidence to justify legislative action outside the context of inversions at this time, and that it would be more prudent to await the receipt and analysis of taxpayer data on earnings stripping submitted through the new Form 8926. Proponents of this view may also believe that the implementation of the new form should increase compliance with section 163(j). In response, some argue that it will be at least several years before careful analyses can be performed on any data submitted through Form 8926, and that there is currently sufficient concern and anecdotal evidence regarding earnings stripping by foreign-controlled domestic corporations to justify strengthening the substantive earnings stripping rules now, while continuing to analyze data as it becomes available.

Other types of earnings stripping

The proposal does not address earnings stripping transactions involving the payment of deductible amounts (by expatriated entities or foreign-controlled domestic corporations) other than interest (e.g., rents, royalties, and service fees), or the payment of deductible amounts by taxpayers other than corporations.[717] These transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to earnings stripping is needed. The Treasury Department's examination of payments declared on Form 5472 by seven expatriated entities suggests that, although the majority of earnings stripping by expatriated entities is through interest, some earnings stripping occurs through royalties.[718] Indeed, as opportunities for earnings stripping through interest payments are reduced, taxpayers may find it increasingly attractive to strip earnings through other means. On the other hand, earnings stripping may be more readily achieved through the use of debt than through other means.[719]

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[717] However, a separate proposal contained in the President's fiscal year 2012 budget would disallow the deduction for nontaxed reinsurance premiums paid to affiliates. See Part V.C.5 of this document for a discussion of that proposal.

[718] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 22.

[719] The Treasury Department notes that capitalizing a foreign-controlled domestic corporation with a disproportionate amount of debt to engage in earnings stripping does not generally require any real movement of assets or a change in the business operations of the corporation. In contrast, the use of royalties or other deductible payments may require a real change in business operations. See *ibid.*, p. 7 & n.1.

Prior Action

The President's fiscal year 2011 budget proposals contained an identical earnings stripping proposal. The President's fiscal year 2009 and 2010 budget proposals contained a similar proposal, except that it provided that the 50-percent of adjusted taxable income threshold generally continued to apply to interest on guaranteed debt. The President's fiscal year 2005, 2006, 2007, and 2008 budget proposals contained a similar, but broader, proposal that would have applied regardless of whether an inversion had occurred. The President's fiscal year 2004 budget proposals contained a different earnings stripping proposal that would have modified the safe harbor provision, reduced the adjusted taxable income threshold, added a new disallowance provision based on a comparison of domestic-to-worldwide indebtedness, and limited carryovers.

In 2010, the House twice passed a provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign related party may not be reduced under a U.S. treaty unless such withholding tax would be reduced under a U.S. treaty if such payment were made directly to the foreign parent corporation.[720] The House passed the same provision in 2008 and 2009.[721] In 2007, the House passed a similar, but somewhat broader provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign related party may not be less than the amount which would be imposed if the payment were made directly to its foreign parent corporation.[722] In each of these cases, the provision would apply to all deductible payments to foreign related parties, and not solely to interest.

In 2006, the Senate passed a provision applicable to certain expatriated entities that would have eliminated the safe harbor and reduced the present-law threshold of 50 percent of adjusted taxable income to 25 percent for both net interest expense and excess limitation.[723]

In 2004, prior to AJCA's enactment, the Senate passed a provision that would have tightened the interest stripping rules for corporations that had engaged in certain inversions. For these corporations, the proposal would have eliminated the debt-to-equity safe harbor, reduced the threshold for excess interest expense to 25 percent of adjusted taxable income, and modified the excess limitation threshold so that 25 percent of adjusted taxable income over a corporation's net interest expense for a year could be carried forward three years.[724]

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[720] H.R. 4849, 111th Cong. sec. 301 (2010); H.R. 847, 111th Cong. sec. 301 (as passed by House, September 29, 2010).

[721] H.R. 3962, 111th Cong. sec. 561 (2009); H.R. 6275, 110th Cong. sec. 203 (2008). The provision was identical to one introduced by the Chairman of the Committee on Ways and Means in 2007. H.R. 3970, 110th Cong. sec. 3204 (2007).

[722] H.R. 2419, 110th Cong. sec. 12001 (2007).

[723] H.R. 4297, 109th Cong. sec. 441 (2006); see H.R. Rep. No. 109-455, pp. 245-50 (2006).

[724] S. 1637, 108th Cong. sec. 441(d)(2) (2004).

7. Proposal to modify the tax rules for dual-capacity taxpayers

Present Law

The United States taxes its citizens and residents (including domestic corporations) on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. To mitigate this possibility, the United States generally provides a credit against U.S. tax liability for foreign income taxes paid or accrued.[725]

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax. In general, a foreign levy is considered a creditable tax if it is substantially equivalent to an income tax under U.S. tax principles. Under the present Treasury regulations, a foreign levy is considered a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country.[726]

Dual-capacity taxpayers

A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from the foreign country is considered a "dual-capacity taxpayer."[727] A "specific economic benefit" is broadly defined as an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general.[728] An example of a specific economic benefit includes a concession to extract government-owned petroleum. Other examples of economic benefits include property; a service; a fee or other payment; a right to use, acquire or extract resources, patents, or other property that a foreign country owns or controls (as provided by the regulations); and a reduction or discharge of a contractual obligation.

Treasury regulations addressing payments made by dual-capacity taxpayers were developed in response to the concern that payments which purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense.[729] To the extent that a taxpayer meets the

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[725] Sec. 901.

[726] Treas. Reg. sec. 1.901-2(a)(2)(i).

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

[728] Treas. Reg. sec. 1.901-2(a)(2)(ii)(B).

[729] Testimony of Treasury Secretary Schultz, Hearings on "Windfall" Excess Profits Tax before the House Committee on Ways and Means, 93rd Cong., 2d Sess. 151 (1974).

definition of a dual-capacity taxpayer, the taxpayer may not claim a foreign tax credit for the portion of the foreign levy that is paid for the specific economic benefit.[730] Treasury regulations require that a dual-capacity taxpayer, similar to other taxpayers, must establish that the foreign levy meets the requirements of section 901 or section 903.[731] However, the regulations require that a dual-capacity taxpayer use either a facts and circumstances method or a safe harbor method in establishing the foreign levy is an income tax.[732]

Under the facts and circumstances method, a separate levy is creditable to the extent that the taxpayer establishes, based on all the relevant facts and circumstances, the amount of the levy that is not paid as compensation for the specific economic benefit.[733] For purposes of applying the facts and circumstances method, the foreign country need not have a generally imposed income tax.

A dual-capacity taxpayer alternatively may choose to apply the safe harbor method on a country-by-country basis to determine whether a levy is a creditable tax.[734] Under the safe harbor method, if the foreign country has a generally imposed income tax, the taxpayer may credit the portion of the levy that application of the generally imposed income tax would yield provided that the levy otherwise constitutes an income tax or an in lieu of tax. The balance of the levy is treated as compensation for the specific economic benefit.[735] If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable U.S. Federal tax rate, applied to net income, is treated as a creditable tax.[736] In general, a foreign tax is treated as generally imposed for this purpose even if it applies only to persons who are not residents or nationals of that country.[737]

After the promulgation of the regulations, many dual-capacity taxpayers elected the safe harbor method for determining what portion, if any, of the separate foreign levy they paid would be treated as a creditable income tax. However, in 1999, the Tax Court in *Exxon Corp. v. Commissioner* determined that the entire amount of the petroleum revenue tax paid by Exxon to

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[730] Treas. Reg. sec. 1.901-2A(a)(1).

[731] Treas. Reg. sec. 1.901-2A(b)(1).

[732] Treas. Reg. sec. 1.901-2A(c).

[733] Treas. Reg. sec. 1.901-2A(c)(2)(i).

[734] A taxpayer may make an election to use the safe harbor method with respect to one or more foreign states. The election applies to the year of the election and to all subsequent taxable years unless revoked. In the case of a member of an affiliated group that files a consolidated U.S. tax return, the election is made by the common parent and applies to all members of the affiliated group. See Treas. Reg. sec. 1.902-2A(d)(1).

[735] Treas. Reg. sec. 1.901-2A. Detailed rules are provided for determining the amount that imposition of the generally applicable tax to the dual-capacity taxpayer would yield, based on the taxpayer's gross receipts, costs and expenses, and other factors.

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

[737] See Treas. Reg. sec. 1.903-1(b)(3), Ex. 4.

the U.K. government did not constitute compensation for a specific economic benefit and would thus qualify as tax for purposes of the foreign tax credit.[738] The Court considered that Exxon entered into an arm's length licensing agreement with the U.K. government to gain access to the North Sea oil fields prior to the enactment of the petroleum revenue tax, and determined that Exxon's right to explore, develop, and exploit petroleum resources was dependent on the licensing agreement and payment of license fees under that agreement and not in exchange for payment of the tax. Subsequent to the decision in *Exxon*, anecdotal evidence suggests that a significant number of dual-capacity taxpayers revoked their safe harbor elections and adopted the facts and circumstances method to argue for tax treatment for the entire amount of the qualifying levy.

Limitation on the use of foreign tax credits

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[739] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the immediately preceding taxable year or carry forward the excess taxes forward 10 years.[740]

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of foreign taxes attributable to income in a separate limitation category that may be claimed as credits may not exceed the proportion of the taxpayer's total U.S. tax liability which the taxpayer's foreign-source taxable income in that separate limitation category bears to the taxpayer's worldwide taxable income. The separate limitation rules are intended to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income.[741]

Special rule for foreign oil and gas income

A special limitation applies with respect to taxes on combined foreign oil and gas income applied prior to the foreign tax credit limitation discussed above.[742] This limitation was adopted

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[738] *Exxon v. Commissioner*, 113 T.C. 338 (1999) (hereinafter "*Exxon v. Commissioner*"). See also *Philips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

[739] Secs. 901 and 904.

[740] Sec. 904(c).

[741] Sec. 904(d).

[742] Sec. 907. For taxable years beginning before January 1, 2009, the components of what is now defined as combined foreign oil and gas income included foreign oil and gas extraction income ("FOGEI") and foreign oil

prior to the issuance of the regulations providing the rules discussed above for dual-capacity taxpayers and was intended to address the concern that payments made by oil companies to many oil-producing nations were royalties disguised as tax payments.[743] Additionally, the limitation sought to prevent the crediting of high foreign taxes on foreign oil and gas income against the residual U.S. tax on other types of lower-taxed foreign source income.[744]

Under this special limitation, amounts claimed as taxes paid on combined foreign oil and gas income are creditable in a given taxable year (if they otherwise qualify as creditable taxes) only to the extent they do not exceed the applicable U.S. tax on that income. The applicable U.S. tax is determined for a corporation as the product of the amount of such combined foreign oil and gas income for the taxable year and the highest marginal tax rate for corporations.[745] Any excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year.[746] Amounts that are not limited under section 907 (relating to combined foreign oil and gas income discussed above) are included in the general basket or passive basket (as applicable) for purposes of applying the section 904 limitation.

Description of Proposal

In the case of a dual-capacity taxpayer, the proposal allows a taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. The proposal replaces the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax. The proposal also converts the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The proposal yields to United States treaty obligations to the extent that they allow a credit for taxes paid or accrued on certain oil or gas income.

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related income ("FORI"). Under the prior rules, FOGEI and FORI were subject to separate limitations under section 907. Pub. L. No 110-343, sec. 402(a). Amounts claimed as taxes paid on FOGEI of a domestic corporation qualified as creditable taxes (if they otherwise so qualified), if they did not exceed the product of FOGEI multiplied by the highest marginal U.S. tax rate on corporations. A separate limitation was deemed to apply to FORI which theoretically applied in certain cases where the foreign law imposing such amount of tax is structured, or in fact operated, so that the amount of tax imposed with respect to FORI generally was "materially greater," over a "reasonable period of time," than the amount generally imposed on income that was neither FORI nor FOGEI. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress*, (JCS-1-09), March 2009, p. 358.

[743] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, (JCS-38-82), December 31, 1982, sec. IV.A.7.a, fn 63.

[744] H.R. Conf. Rept. No. 103-213, p. 646 (1993).

[745] Sec. 907(a). For an individual, the limitation is the product of the amount of such combined foreign oil and gas income for the taxable year and a fraction, the numerator of which is the tax against which the credit under section 901(a) is taken and the denominator of which is the taxpayer's entire taxable income.

[746] Sec. 907(f).

Effective date.–The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

The proposal addresses the distinction between creditable taxes and non-creditable payments that are made in exchange for a specific economic benefit by denying a foreign tax credit for amounts paid by a dual-capacity taxpayer that exceed the foreign tax that would be paid if the taxpayer were not a dual-capacity taxpayer. Thus, the proposal would create a non-rebuttable presumption that a tax paid by a dual-capacity taxpayer to a foreign government is for a specific economic benefit to the extent the tax exceeds the tax that would be paid by a non-dual-capacity taxpayer.

As discussed above, the catalyst for the present regulations governing the creditability of payments made by dual-capacity taxpayers was a concern that payments purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense. The present regulations mitigate this concern, but under either the facts and circumstances or safe-harbor method, a foreign levy is treated as a creditable tax, despite there being a lower or no generally imposed income tax on persons other than dual-capacity taxpayers.[747] Thus, under the present regulatory regime, there is a general presumption that the foreign levy represents a tax, even where the levy is either imposed at a higher rate or imposed solely on dual-capacity taxpayers. The proposal effectively reverses that presumption by allowing a dual-capacity taxpayer to treat as income tax only the portion of the foreign levy that the dual-capacity taxpayer would pay had it not been a dual-capacity taxpayer.

Although primarily applicable to oil and gas producers (and other companies engaged in mineral extraction businesses), the "dual-capacity" taxpayer provisions are broadly applicable to any taxpayer that is treated under the regulations as receiving a specific economic benefit from a foreign government.[748] Thus, for example, a corporation engaged in a banking business that loans funds to a foreign government may meet the definition of a dual-capacity taxpayer and therefore be subject to the provisions in the Administration's proposal. As a result, if the foreign country imposes no income tax on persons other than dual-capacity taxpayers, the taxes paid by the bank would not be creditable.[749]

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[747] As discussed above, under the safe harbor method in a foreign jurisdiction that has a generally imposed income tax, the creditable foreign tax cannot exceed the liability of the taxpayer had the taxpayer been subject to the general income tax. If the foreign jurisdiction has no generally imposed income tax, the creditable foreign tax cannot exceed the applicable U.S. federal tax rate. See Treas. Reg. sec. 1.901-2A(e).

[748] The proposed Energy Security and Corporate Accountability Act of 2007 includes a provision that is based on prior versions of this proposal but only applies to dual-capacity taxpayers that are major integrated oil companies (as defined in sec.167(h)(5)(B)). See S. 1287, 110th Cong. sec. 3 (2007).

[749] Compare with Treas. Reg. sec. 1.901-2A(c)(2)(ii), Example 1. In this example, the taxes paid by the bank were creditable because the bank met its burden of proof under the facts and circumstances method.

Present law arguably fails to achieve the appropriate allocation between a payment for a specific economic benefit and a creditable tax in those cases where the foreign country either imposes a levy on an item, but does not otherwise generally impose an income tax, or imposes a higher levy on dual-capacity taxpayer than the levy imposed on non-dual-capacity taxpayers. Thus, the proposal would ensure that the levy is not a payment for a specific economic benefit.[750]

Moreover, the proposal provides a clear, objective test to determine what portion of the foreign levy, if any, reflects payment for a specific economic benefit. Thus, unlike the facts and circumstances test which has been the subject of controversy between the IRS and taxpayers, the proposal provides for a more objective standard that would be easier to administer.

Nonetheless, the potential for double taxation created under the proposal arguably does not constitute sound tax policy. Instead, if the dual-capacity taxpayer can establish that it is already paying fair compensation to the foreign country for the economic benefit received from that country, amounts paid pursuant to the foreign levy on net income or a levy on excess profits should constitute a creditable tax, notwithstanding that the foreign country imposes lower or no income tax on non-dual-capacity taxpayers.[751]

Furthermore, a fundamental assumption behind the proposal, that countries generally seek to impose an equal tax burden on all taxpayers and therefore any additional tax burden imposed solely on dual-capacity taxpayers reflects payment for a specific economic benefit, is arguably incorrect. Taxing jurisdictions often impose different levels of tax burden on different industries according to various factors including the relative mobility of a particular industry. A taxpayer in a relatively immobile industry, such as a company engaged in a natural resource extraction industry, is compelled to operate within the natural resource's jurisdiction notwithstanding a relatively high tax rate. In contrast, a taxpayer in a relatively mobile industry may have more flexibility in choosing the taxing jurisdiction in which it is established. To attract in-country investments of mobile industries, taxing authorities may offer incentives to such industries, including a lower tax rate. Thus, the additional tax burden on oil companies, as well as others operating in immobile industries, is arguably not a payment for a specific economic benefit, but simply reflects the jurisdiction's ability to impose a higher tax on an immobile industry.

Those opposing the proposal also point out that the major U.S. based oil companies would be disadvantaged relative to foreign competitors in bidding for new projects as a result of

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[750] For example, under a recently enacted tax reform, Qatar, one of the world's largest petroleum exporters, replaced its progressive corporate tax rate schedule of up to 35 percent to a flat rate of 10 percent that only applies to foreign investors and companies. Taxable entities carrying on oil operations (as defined) are subject to tax under the provisions of the agreements they entered into with the state. The tax rate, however, may not be less than 35 percent. IBFD Tax News Services, Report from Mr. Salah Gueydi, Qatar, *New Income Tax Law - details*, January 13, 2010. Also, in addition to other taxes it levies on oil and gas extraction activities (e.g., the Petroleum Revenue Tax), the United Kingdom taxes oil and gas operations at a higher rate of 30 percent (i.e., the Ring Fence Corporate Tax) compared to a standard corporate tax rate of 28 percent and small companies rate of 21 percent. Business Operations in the United Kingdom, Tax Management Portfolio No. 997-5th, IX, J.

[751] See, e.g., *Exxon v. Commissioner*.

the increased costs.[752] This reduced competitiveness could, it is contended, impair energy security in the United States.

The proposal also includes a separate foreign tax credit limitation category that applies to combined foreign oil and gas income and replaces the present-law special limitation for combined foreign oil and gas income under section 907. Some have argued that the original concerns that gave rise to the section 907 rules – royalties being disguised as foreign levies and the cross-crediting of taxes paid at high rates on foreign oil and gas related income against U.S. tax on other low-taxed income – have been sufficiently addressed by other provisions and that section 907 adds unnecessary complexity and should be repealed.[753] Arguably, the disguised royalties issue was addressed by the dual-capacity taxpayer rules. However, as discussed above, the present law dual-capacity taxpayer rules permit certain foreign levies to be treated as creditable even though the foreign country imposes lower or no levies on non-dual-capacity taxpayers. If the proposed modifications to the dual-capacity taxpayer rules were enacted, these changes may render section 907 unnecessary in preventing crediting of disguised royalties. However, the cross-crediting of high taxes paid on extraction income against other income is a section 904 concern that is not addressed by changes to the amount of the foreign levy that qualifies under section 901.

Furthermore, the recent change combining FOGEI and FORI into combined foreign oil and gas income allows for substantial cross-crediting of extraction taxes against U.S. tax on low-taxed downstream FORI income. By replacing section 907 with a separate section 904 limitation category for foreign oil and gas income, the proposal would restrict cross-crediting of oil and gas related taxes against other general category income as well as prevent the use of excess credits on other general category income from offsetting U.S. tax on low-taxed FORI for taxpayers that do not have extraction income. At the same time, the proposal would simplify credit calculations because present law requires that the special section 907 limitation be applied first, followed by application of the section 904 limitation.

Prior Action

Proposals revising the treatment of dual-capacity taxpayers have been included in the President's Fiscal Year 1998, 1999, 2000, 2001, 2010, and 2011 budget proposals. The President's Fiscal Year 1998 proposal included an additional modification with respect to the treatment of foreign oil and gas income under subpart F of the Code which is not included in this proposal.

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[752] In contrast to U.S. dual-capacity taxpayers, many of these foreign competitors may be headquartered in jurisdictions with territorial tax regimes that do not tax active foreign earnings. See, e.g., Testimony of C. Ellen MacNeil on behalf of the American Petroleum Institute, Hearing on the revenue provisions in the President's Fiscal Year 1998 before the House Committee on Ways and Means, 105th Cong. (1997).

[753] U.S. National Foreign Trade Council, Inc., "The NFTC Foreign Income Project: International Tax Policy for the 21st Century," 2002 *Tax Notes Today* 66-57 (December 15, 2001); Statement by Gregory S. Nickerson and Fred Murray of National Foreign Trade Council, Inc. relating to National Foreign Trade Council Comments on Joint Committee on Taxation Study of Overall State of Federal Tax System and Recommendations for Simplification before the Committee on Finance United States Senate, 107th Congress, May 14, 2001.

D. Reform Treatment of Insurance Companies and Products

1. Modify rules that apply to sales of life insurance contracts

Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[754]

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.[755] Under the limitation, the excludable amount may not exceed the sum of: (1) the actual value of the consideration; and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if: (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract;[756] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[757]

In the case of certain accelerated death benefits and viatical settlements,[758] special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated

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[754] Sec. 101(a)(1).

[755] Sec. 101(a)(2).

[756] Sec. 101(a)(2)(A).

[757] Sec. 101(a)(2)(B).

[758] Sec. 101(g).

as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts.

In Rev. Rul. 2009-13,[759] the IRS ruled that income recognized under section 72(e) on surrender of a life insurance contract with cash value to the life insurance company is ordinary income. In the case of sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain.

In Rev. Rul. 2009-14,[760] the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

Description of Proposal

The proposal imposes reporting requirements on the buyer in the case of the purchase of an existing life insurance contract with a death benefit equal to or exceeding $500,000. The proposal also imposes reporting requirements on the issuing insurance company in the case of the payment of benefits under a purchased contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is: (1) the purchase price; (2) the buyer's and seller's taxpayer identification numbers; and (3) the name of the issuer of the contract and the policy number.

When a policy benefit is paid under the contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports: (1) the gross amount of the payment; (2) the taxpayer

[759] 2009-21 I.R.B. 1029.

[760] 2009-21 I.R.B. 1031.

identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract.

In addition, the proposal modifies the present-law rules providing exceptions to the limitation on the excludable amount of a death benefit. Under the proposal, the exceptions do not apply to buyers of policies.

Effective date.–The proposal is effective for sales or assignments of interests in life insurance contracts and payments of death benefits for taxable years beginning after December 31, 2011.

Analysis

Reporting

The proposal is directed to the issue of collection of tax on amounts that are includable in income with respect to a life insurance contract that has been transferred for value. Because information about the identity of parties to transfers of contracts, amounts paid for transferred contracts, and payments under transferred contracts is not now reported, enforcement of present-law income inclusion requirements is needlessly difficult. Taxpayers who are parties to transfers of life insurance contracts may have a reduced incentive accurately to measure gain on transfers and on payments under transferred contracts, or even to include any amount in income, because they believe enforcement of the requirement of inclusion is impaired by the lack of reporting. Thus, it is argued, the reporting provisions are needed to improve voluntary compliance with present law.

Purchasers of life insurance contracts (such as viatical settlement or life settlement companies, or others that securitize purchased life insurance contracts) should not be more easily able to escape tax on their business income than other business taxpayers because enforcement may be difficult due to lack of reporting. The perception that taxpayers might not include income because enforcement of the inclusion requirement may be difficult can be corrected, advocates argue, by making it very clear that enforcement of the inclusion requirement is easy using the reported information.

Opponents of the reporting requirement may argue that the reporting requirements are burdensome. They may argue that processing and putting to use all the information that would be required by the proposal is an inefficient use of IRS resources, which might be better employed addressing other, more pressing tax issues. They may further argue that the level of detail of the reporting under the proposal is excessive, and that if any reporting of transfers of life insurance contracts is proposed, it should be more limited than that proposed. On the other hand, some might point to present-law reporting requirements applicable to banks and mutual funds, and could argue that the reporting under the proposal is no more burdensome.

The mechanics of the reporting requirement could be criticized as not fully developed. The proposal does not address the mechanism for reporting the purchase price in the case of periodic payments for the purchase of an insurance contract. On the other hand, these details could be developed either as Congress drafts the proposal, or as it is implemented by the IRS.

The reporting requirement on payment of a death benefit under a contract could also be criticized as somewhat complex, because it applies to payments with respect to only those contracts, the death benefit under which equals or exceeds $500,000. This dollar threshold requires taxpayers to distinguish among contracts for reporting purposes. If, by contrast, the reporting requirement applied to any payment under a contract, regardless of the size of the death benefit, then this determination would be eliminated, and the payor would report the taxable portion (if any) of the payment. Nevertheless, those opposed to the proposal's reporting requirements generally on the grounds that they are unduly burdensome might argue that expanding the circumstances in which reporting applies would exacerbate the problem.

Opponents might argue that it is inconsistent to modify the reporting requirements only for purchases of an existing life insurance contract with a death benefit equal to or exceeding $500,000, while modifying the exclusion rules regardless of the amount of the death benefit under the contract. If reporting is inadequate under present law, it could be argued, it should be applied to all cases in which income should be reported, not just some; or alternatively, the modifications of the exclusion rules should parallel the reporting rules, if the underreporting is principally a problem at that level of death benefits under purchased contracts.

On the other hand, most reporting requirements under present law require reporting only for amounts over a dollar threshold, and this proposal is arguably consistent with that approach.

Modifying exceptions to transfer for value rule

Opponents of the modification to the present-law exceptions may argue that the proposal is not sufficiently detailed or specific, and that a vague proposal to modify the exceptions could have a chilling effect on legitimate business transactions that are not intended to be covered by the proposal. On the other hand, it could be noted that the proposal would become specific during the legislative process, before any provision would be enacted.

The promulgation of guidance by the IRS in Rev. Ruls. 2009-13 and 2009-14 may prompt the argument that legislative change to the transfer for value rule is not needed, as these rulings address all the important open questions of determining the basis of a life insurance contract and determining the character of gain on transactions involving the contract. It is not necessary to repeal the exceptions to the transfer for value rules in the case of purchased contracts, once these issues are clarified for taxpayers.

Nevertheless, basis and character are not the issues involved in the exceptions: instead, the issue is whether gain is recognized at all. The exceptions may have arisen long ago when transfers of life insurance contracts were relatively rare and often took place among family members or owners of closely held businesses. In the past 10 or 20 years, however, an enormous and growing secondary market for life insurance contracts has developed.[761] Transfers of life

[761] See, e.g., Marc Lifsher, "Treating Death as a Commodity: A Growing Industry Involves Buying, Selling and Profiting from Life Insurance," *Los Angeles Times* (February 20, 2008), A1; Genevieve Cua, "Investing in Second-Hand Life; This Fund Pools Policies Sold by the Insured," *Business Times Singapore* (July 2, 2008), section F; Anita Juslin, "Insuring a Controversy: the Wealthy are Selling Their Life Insurance Policies for Profit," *Washington Post* (November 27, 2007), D-l.

insurance contracts are significantly more common and typically involve transactions among parties that are not family members or involved in a closely held business together. Rather, buyers of life insurance contracts are typically participants in a market for financial intermediation. The exceptions to the transfer for value rule should not apply in this context, it is argued.

Prior Action

A similar proposal was included in the President's fiscal year 2010 and 2011 budget proposals.

2. Modify dividends received deduction for life insurance company separate accounts

Present Law

Dividends received deduction

In general

A corporate taxpayer may partially or fully deduct dividends received.[762] The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

Limitations on dividends received deduction under section 246(c)(4)

The dividends received deduction is not allowed with respect to stock either (1) held for 45 days or less during a 91-day period beginning 45 days before the ex-dividend date, or (2) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property.[763] The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.[764]

Expenses and interest relating to tax-exempt income

No deduction is allowed for interest on debt incurred or continued to purchase or carry obligations, the interest on which is exempt from tax.[765] This rule applies to both individuals and corporations, and incorporates a tracing notion.

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[762] Sec. 243 et seq. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

[763] Sec. 246(c).

[764] Sec. 246(c)(4). For this purpose, the holding period is reduced for periods in which (1) the taxpayer has an obligation to sell or has shorted substantially similar stock; (2) the taxpayer has granted an option to buy substantially similar stock; (3) under Treasury regulations, the taxpayer has diminished its risk of loss by holding other positions with respect to substantially similar or related property.

[765] Sec. 265(a)(2).

In the case of financial institutions, a pro rata interest deduction disallowance rule applies. Under that rule, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to tax-exempt interest, based on the ratio of the adjusted basis of the taxpayer's tax-exempt obligations to the adjusted basis of all its assets.[766] An exception to the pro rata disallowance rule applies in the case of tax-exempt obligations of a qualified small issuer.

Property and casualty insurance company proration rules

The taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.

A proration rule applies to property and casualty insurance companies. In calculating the deductible amount of its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts the company owns.[767] This proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, and from other untaxed amounts.

Life insurance company proration rules

A life insurance company is subject to proration rules in calculating life insurance company taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income.

Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.[768] Similarly, under the proration rules, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,[769] but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that

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[766] Sec. 265(b).

[767] Sec. 832(b)(5).

[768] Secs. 807(a)(2)(B) and (b)(1)(B).

[769] Secs. 805(a)(4), 812.

would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.[770] Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.[771]

Gross investment income includes specified items.[772] The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, short term capital gains, and trade or business income. Gross investment income does not include gain (other than short term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) a portion of policyholder dividends.[773] Policy interest is defined to include required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.[774]

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[770] Sec. 812(a).

[771] Sec. 812(c).

[772] Sec. 812(d).

[773] Sec. 812(b)(1). This portion is defined as gross investment income's share of policyholder dividends.

[774] Legislative history of section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). This concept is referred to in Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84 (December 31, 1984), p. 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (i.e., by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Rev. Rul. 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

In 2007, the IRS issued Rev. Rul. 2007-54,[775] interpreting required interest under section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts. However, Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.[776] No regulations have been issued to date.

Life insurance company tax treatment of variable contracts

General account and separate account

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.[777] The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[778] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,[779] in determining reserves for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed of. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

Description of Proposal

The proposal repeals the present-law proration rules for life insurance companies in which the prorated amount is determined on the basis of the policyholders' share and the company's share of investment income. The proposal substitutes two different proration rules: one for the general account, and one for the separate accounts of a life insurance company.

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[775] 2007-38 I.R.B. 604.

[776] 2007-42 I.R.B.799.

[777] Section 817(d) provides a more detailed definition of a variable contract.

[778] Sec. 807.

[779] Sec. 817.

For the general account, a 15-percent reduction rule applies to the company's deductions, calculated with respect to the dividends received deduction, tax-exempt interest, and policy cash values of the company, similar to the property and casualty insurance company proration rule.

For each separate account of the company, the proposal applies the limitations that apply to corporations that are not insurers with respect to the dividends received deduction in the situation in which the corporation has a diminished risk of loss with respect to the stock. This rule applies in the same proportion as the mean of the reserves for the separate account bears to the mean of the total assets of the separate account. Thus, this rule does not apply a fixed percentage like the general account rule.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

In general

The proposal is directed towards improving the accuracy of measurement of income of life insurance companies by modifying the proration rules that limit deductions associated with untaxed income. The proposal also serves to simplify these proration rules, which are rather complex. The proposal aims to improve the clarity of the law and resolve interpretive issues that have arisen in recent years, thus reducing controversies between the IRS and taxpayers.

In analyzing the proposal, it is useful to compare the life insurer proration rules to other present-law rules limiting deductions associated with untaxed income of taxpayers other than life insurers. A further question is why the life insurance company proration rules involve such complex calculations, and whether complexity is inevitable. In addition, analysis of the proposal may be aided by examining other possible options for modifying the life insurance company proration rules.

Expenses and interest relating to tax-exempt income of taxpayers generally

For taxpayers other than insurance companies, present-law section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax (tax-exempt obligations).[780] The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations. Similarly, present law disallows a deduction for expenses allocable to tax-exempt interest income.

These present-law limitations are expressions of the concept that, under an income tax, expenses are deductible only if related to the production of income subject to tax. This policy concept is not expressed uniformly throughout the tax law, it may be observed. Examples of the

[780] Sec. 265. A pro rata interest expense allocation rule applies in the case of financial institutions, and exceptions to the general rule apply in the case of certain types of tax-exempt obligations (sec. 265(b)).

failure of the tax law to match deductible expenses with taxable income can be cited, such as the allowance of home mortgage interest as a deduction though the imputed rental value of residence in the home is not includable in income for individuals. However, these instances may reflect nontax social policies that are implemented through the tax law, practical difficulties of valuation or administrability, or historical norms that are broadly accepted even though inconsistent with fundamental tax policy. The proration rule applicable to property and casualty insurers could also be cited as perhaps a partial failure to match deductible expenses with taxable income. That rule disallows a deduction for expenses of earning untaxed income at a flat 15 percent rate. If untaxed income represents more than 15 percent of after-tax income, the rule may not operate effectively to prevent tax arbitrage.[781]

Historical background

In general

Proration rules limiting deductions associated with untaxed income of life insurance companies were adopted as part of the earliest Federal income tax rules applicable to life insurers in 1921.[782] Those rules required that the reserve deduction for investment income be reduced by tax-exempt interest. In 1928, however, the Supreme Court held that this deduction limitation rule was unconstitutional because it indirectly imposed Federal tax on State obligations.[783]

In subsequent legislation, the proration rule was restructured,[784] and ultimately in 1959 a further revised proration rule was adopted providing that taxable investment yield of a life insurance company was reduced by the company's share of tax-exempt interest and deductible dividends received.[785] The 1959 provision included the notions of required interest and an amount retained by the company in determining the company's share of investment income for separate accounts. More generally, the 1959 Act provided for a three-phase system of taxation

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[781] For a discussion of a proposal to modify the property and casualty insurer proration rule, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal*, JCS-2-00, March 6, 2000, pp. 425-428.

[782] Sec. 245(a)(2) of the Revenue Act of 1921, Pub. L. No. 67-98, 67th Cong. 2d Sess., ch. 136, 42 Stat. 227.

[783] *National Life Insurance Company v. U.S.*, 277 U.S. 508 (1928), in which the Court relied on "settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves," and held that "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

[784] Sec. 163 of the Revenue Act of 1942, Pub. L. No. 77-753, 77th Cong. 2d Sess., enacting section 202(b) of the Internal Revenue Code (1942), 56 Stat. 798, 899. See also Letter of Walter C. Welsh, Executive Vice President, and William Elwell, Senior Counsel, American Counsel of Life Insurers, to the Honorable Eric Solomon, Assistant Secretary for Tax Policy, U.S. Treasury Department, and the Honorable Donald L. Korb, Chief Counsel, Internal Revenue Service, June 26, 2008, p. 5-6, and Harold Wurzel, "Tax-Exempt Interest of Life Insurance Companies: A Study in 'Discriminatory' Taxation, 70 *Yale Law Journal* 15 (1960).

[785] Sec. 801, as enacted in the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 86th Cong., 1st Sess.

of life insurers, under which, generally, gain from operations was taxed only if it exceeded the company's taxable investment income. The rules for taxing life insurance companies were substantially revised in 1984 to eliminate the three-phase system and generally to tax both operating income and investment income.[786] The 1984 revisions retained proration rules for life insurers, and generally retained the 1959 notion that the proration rules are based on a determination of the company's share of income and deductions.

In 1988, the Supreme Court held that imposing Federal tax on interest earned on State bonds does not violate the intergovernmental tax immunity doctrine, and so is not unconstitutional.[787] The life insurance company proration rules have not been substantially modified since the 1988 Supreme Court decision.

The current proration formula for life insurers may provide a benefit independent of the amount of any reserve deduction or tax-exempt interest and deductible dividend income because of the way the calculation treats investment expenses. The company's share increases when the actual net investment income is less than the statutorily defined net investment income. That is, a company receives a benefit from the proration rules for a separate account if the amount retained by the company is greater than five percent of defined gross investment income. This may be particularly true of separate accounts that attribute more of their appreciation to items excluded from the definition of gross investment income, such as capital gains.

Sources of complexity derived from 1959 law

It could be argued that the complexity of the rules and the calculations under the life insurance company proration provisions is largely attributable to the origin of the rules over 90 years ago and Congress' multiple attempts during the period to express tax policy in a manner that did not violate Constitutional doctrine. The complexity of the current proration rules may be exacerbated by the application of a few details of the 1959 Act three-phase system under modern rules shorn of that context.

The company's share served multiple purposes under the 1959 Act. It served to prorate the deduction for tax-exempt interest and dividends received as under present law. It also determined the amount of taxable investment yield included in taxable investment income. While an increase in the company's share under present law necessarily lowers taxable income, an increase in the company's share under prior law had a differing effect on taxable income depending on whether a company's gain from operations exceeded taxable investment income and the importance of tax-exempt interest and deductible dividends in investment yield.

Similarly, under the 1959 Act, gross investment income served multiple purposes. Not only did it determine the company's share for proration, but also it provided the basis for calculation of investment yield and taxable investment income. Gross investment income

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[786] See Title II, Life Insurance Provisions, Deficit Reduction Act of 1984, Pub. L. No. 98-369, July 18, 1984.

[787] *South Carolina v. Baker*, 485 U.S. 505, reh'g denied, 486 U.S. 1062 (1988).

includes only positive ordinary income items, perhaps to avoid having to interpret and allocate negative amounts. It may be argued that the selection of items included in the current definition of gross investment income stem primarily from this function under prior law, rather than the present law proration function, and that the definition of gross investment income should now be tailored to mesh with the proration rule where it is used today.

Furthermore, retention of the 1959 Act concepts arguably is no longer necessitated by concern for potential unconstitutionality. The Federal income tax policy not to allow a deduction for expenses of earning amounts that are not included in income could be expressed more simply in the life insurance tax rules. An explicit statutory statement of the operation of the proration of the dividends received deduction would be simplifying. Administrability of the law would be enhanced, and disputes would be reduced, if reliance on arcane, layered pre-1984 regulations were no longer an interpretive option.

If the problem is incorrect or aggressive taxpayer positions under the proration rule (as under any present-law rule), the IRS can address this through enforcement action. If this is the situation, perhaps legislative change is not needed. To the extent that the problem arises from aggressive interpretation of the current rules, it could be countered that a case by case approach, potentially leading to the expense of litigating each taxpayer's case, may be an inefficient use of government and taxpayer resources, without effectively clarifying the law in all circuits or giving a near-term answer to all taxpayers.

Nevertheless, enforcement of the law may not be the sole or even the principal issue: rather, clarification of, or change to, the law arguably is needed to eliminate uncertainty about how to determine interest when present law refers to "another appropriate rate" (in the flush language of section 812(b)(2)). In short, a change is needed to the legislative language to state a clear rule. Alternatively, Treasury Department guidance is needed to clarify application of the current rules.[788] However, further administrative guidance may be viewed as insufficient or inadequate without a legislative pronouncement of the rules.

Operation of the proposal

Simplification

By eliminating the investment income-based rules of section 812, the proposal achieves significant simplification compared to present law. Both the 15-percent rule for general accounts and rule for separate accounts based on section 246(c)(4) eliminate many aspects of the present-law proration rule which are derived from 1959 Act concepts and which are no longer otherwise

[788] Arguably, the rules were relatively clear − if complex − prior to the 2003 IRS issuance of Technical Advice Memoranda that addressed some issues but left others open and the subsequent issuance and suspension of Rev. Rul. 2007-54 which set forth a different approach. It is possible that these developments served to fuel disputes between the IRS and taxpayers based on differing interpretations of the law. See Susan J. Hotine, "Proration for Segregated Asset Accounts − How is the Company's Share Computed?," 3 *Taxing Times* 1 (September 2007); Richard N. Bush and Greg L. Stephenson, "Separate Account DRD Under Attack: Five Decades of Practice Regarding Company Share Computation Ignored," *The Insurance Tax Review* 39 (January 2008); and Susan J. Hotine, "Proration for Segregated Asset Accounts − Part Two," 4 *Taxing Times* 21 (February 2008).

utilized in the Federal income tax rules for life insurers. The elimination of these outdated concepts eliminates substantial complexity in the definitions and the operation of the proration rule.

Selection of 15 percent for general account proration

However, the proposal could be criticized for adopting the 15-percent proration of the property and casualty insurance rules, which is known to be ineffective at preventing tax arbitrage. The property and casualty industry is a substantial holder of tax-exempt bonds,[789] illustrating that the 15-percent rule is no deterrent.

A more effective variant of the 15-percent rule might be to base the percentage on the amount of tax-exempt obligations the company holds, rather than using a flat percentage. Under this approach, the proration percentage could be a percentage determined by the ratio of the adjusted basis of the company's tax-exempt assets to the adjusted basis of all its assets. Thus, for example, the life insurer would reduce specified deductions by this percentage of (1) the insurer's tax-exempt interest,[790] (2) the deductible percentage of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts, by analogy to the property and casualty insurance company rule.

Different rules for general account and separate account proration

The proposal could also be criticized for applying a different proration rule for the general account and for the separate accounts of a company. Even though current State insurance company regulation limits shifting between general and separate accounts, the creation of disparate Federal tax rules for these accounts could create perverse incentives to shift assets − or products − between the general account and separate accounts. Indeed, because the proposal's 15 percent proration for the general account may in many instances be less effective than the proration rule proposed for the separate account, an economic incentive to shift to the general account may result. This incentive could give rise to pressure to modify State regulations limiting such shifting. Moreover, the proposal could have disparate impacts as between companies, depending on their mix of business. For example, companies that do not sell variable annuities or other variable products, and whose pricing and profits are driven significantly by mortality costs, would benefit from the 15 percent general account rule, because

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[789] See, e.g., Dan Seymour, "Muni Holdings Beef Up," *The Bond Buyer* (March 12, 2010), stating, "[t]he biggest buyers of municipal bonds other than retail are property and casualty insurers, which accumulated $7.8 billion in the fourth quarter [of 2009] to bring their hoard to $412.6 billion." A 2007 report of the Insurance Research Council states that as of the end of 2005, property and casualty insurers held $320 billion of tax-exempt bonds; a related press release stated, "[m]unicipal bonds make up a large portion of the investment portfolios of many property-casualty insurers." See "IRC Report Documents Property-Casualty Insurance Industry Investments in Municipal Bonds," June 27, 2007, http://www.ircweb.org/news/20070620.pdf.

[790] The present-law definition of tax-exempt interest in section 832 for this purpose is retained under the proposal. Thus, unlike the rule for financial institutions, no exception is provided for small-issuer tax-exempt obligations.

relatively few of their assets are separate account assets. By contrast, companies whose product lines emphasize variable contracts and that consequently have larger separate account assets are impacted to a greater degree by the more rigorous proration rule.

Whether the effect of the proposal favoring general account assets and products is considered nothing more than a tax-induced distortion, or is alternatively viewed as a desirable incentive to achieve a nontax policy goal, depends on an analysis of the merits of maintaining general accounts and separate accounts. While it could be argued that the proposal could motivate taxpayers to shuffle assets between the separate account and the general account to maximize the Federal tax benefit, current State regulatory rules prevent shifting of assets (or income from assets) between separate accounts, or between a separate account and the general account of a life insurer. However, if these State rules are not changed, a life insurer could respond by charging higher fees for separate account products or by changing its product offerings.

Consideration could be given to applying the rule proposed for separate accounts − which is based on the ratio of the mean of the reserve to the total assets in the account − to both the separate accounts and the general account of life insurers. The ratio could be determined separately for each account, limiting potential inaccuracy in reflecting the actual investment returns of pools of assets.

However, it might be argued that no proration rule should apply to general account assets, because the obligation of the life insurer to policyholders of general account products is more attenuated than its obligation to credit separate account dividends received directly to variable contracts. Thus, perhaps like other corporate taxpayers that are not required to prorate their deduction for dividends received, the general account of life insurers arguably should not be subject to proration. Because life insurers tend to have a relatively low proportion of dividend-paying assets in the general account, imposing a complex proration rule on general account assets may not be worthwhile if the asset mix of general accounts remains low on dividend-producing assets.

On the other hand, money is fungible, and proration of untaxed income is appropriate in any case in which the insurer has a reserve deduction with respect to amounts ultimately payable to a policyholder. Moreover, under present law, no dividends received deduction is allowed to corporate taxpayers for any dividend to the extent the taxpayer is under an obligation to make related payments with respect to similar property.[791] Thus, the concept exists outside the insurance context.

Operation of the separate account rule

An aspect of the proposal that is not clarified is the operation of the section 246(c) rule relating to stock in which the taxpayer's risk of loss is diminished in the context of tax-exempt

[791] Sec. 246(c)(1)(B) provides that no dividends received deduction is allowed in respect of any dividend to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

assets that are not stock. That is, the proration rule applies not only with respect to dividends for which the dividends received deduction is otherwise allowed, but also with respect to other assets generating untaxed income. These assets include tax-exempt debt and insurance policy cash values. For the proposal to be fully administrable, rules would have to be developed to determine when a taxpayer's risk of loss is diminished with respect to these assets.

A possible criticism of the proposal, or of any proposal that reduces deductions pursuant to a change in the proration rule with respect to separate account products, is that the price of the products could increase. The insurer could pass some or all of the increased tax cost through to shareholders, employees, or customers. In fact, if the proration rule does not accurately measure the insurer's income by allowing either too great, or too little, a deduction, the company can share with product purchasers the unintended benefit or detriment of income mismeasurement. If it is not intended to provide either a Federal tax subsidy, or an excessive tax burden, that would affect the price of separate account products of insurance companies, then improving the accuracy and administrability of the life insurance proration rule is a desirable improvement in the tax law.

Merits of proration rules generally

Taxpayers may argue, on horizontal equity grounds, that the proration rules for life insurance companies should not give rise to any reduction in the dividends received deduction, by analogy to nonlife corporations that are not subject to any rule reducing their dividends received deduction. On the other hand, dividend income of life insurance companies is arguably most analogous to operating income of nonfinancial-intermediation businesses. The normal rationale for the dividends received deduction − that it eliminates multiple applications of tax on the same income items while they remain in corporate solution − does not apply if the business the firm engages in includes the earning of dividends on the customers' behalf. Under this view, no portion of the dividends received deduction should be allowed for what is effectively business income or operating income.

A nontax policy line of reasoning might suggest that Federal tax proration rules discouraging insurance companies from investing in tax-exempt bonds could be considered undesirable, because such Federal tax rules have the indirect effect of increasing the borrowing and related costs of the municipalities and other government jurisdictions that issue the bonds. On the other hand, concepts of transparency in government may suggest that Federal subsidies of State and local jurisdictions' borrowing costs should be direct rather than implemented indirectly through the tax code, and should not depend on whether the jurisdiction issues bonds or not. Further, other business taxpayers already are subject to proration rules in the Federal tax law; this line of reasoning should apply to all Federal income tax proration rules, or none, but not to just those relating to life insurance companies.

Prior Action

A somewhat similar proposal was included in the President's fiscal year 2010 and 2011 budget proposals.

3. Expand pro rata interest expense disallowance for company-owned life insurance ("COLI")

Present Law

Inside buildup and death benefits under life insurance contracts generally tax-free

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[792] ("inside buildup").[793] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[794]

Premium and interest deduction limitations with respect to life insurance contracts

Premiums

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[795]

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[792] By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[793] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[794] Sec. 101(a).

[795] Sec. 264(a)(1).

Interest paid or accrued with respect to the contract[796]

No deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual,[797] with a key person insurance exception.[798] This reflects a broadening of the interest deduction disallowance rule that was enacted in 1996.

Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. This rule applies to interest, a deduction for which is not disallowed under the other interest deduction disallowance rules relating to life insurance, for example, interest on third-party debt that is not with respect to a life insurance, endowment or annuity contract. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[799] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who

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[796] Earlier-enacted interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts, known as the "single premium" and "4-out-of-7" limitations. The single premium limitation provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (Sec. 264(a)(2)). Under the general rule to which the 4-out-of-7 limitation is a safe harbor, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise) (Sec. 264(a)(3)). Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven year period is paid by means of such debt.

[797] Sec. 264(a)(4).

[798] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise deductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.

[799] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

The pro rata interest deduction limitation was added in 1997.

Excludability of death benefits

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts[800] (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation). These rules permit an employer to exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.

Description of Proposal

The proposal eliminates the exception under the pro rata interest deduction disallowance rule for employees, officers and directors. The exception for 20-percent owners is retained, however.

Effective date.−The proposal is effective for contracts issued after December 31, 2011. A material change in the death benefit or other material change in the contract causes the contract to be treated as a new contract for this purpose, except that the addition of covered lives under a master contract is treated as a new contract only with respect to the additional covered lives.

Analysis

The proposal is directed to the issue of borrowing against life insurance contracts to achieve tax arbitrage. Businesses that own life insurance on employees and borrow from a third-party lender or from the public can achieve tax arbitrage by deducting interest that funds the tax-free inside buildup on the life insurance (or the tax-deferred inside buildup of annuity and endowment contracts). This opportunity for tax arbitrage results from the exception under the pro rata interest deduction limitation for insurance covering employees and others, it is argued. This tax arbitrage opportunity is being utilized particularly by financial intermediation businesses which often have a relatively large amount of debt in the ordinary course of business. Thus, it is argued, the exception should be repealed.

Some would point to the 2006 legislation as having addressed any undesirable aspects of company-owned life insurance ("COLI"), obviating any need for further tax legislation. By adding a notice and consent requirement, the 2006 legislation removed the risk that insured employees would never know that they were insured by their employers. Similarly, the 2006 requirement that the insured must have been an employee within 12 months before death for the

[800] Sec. 101(j).

employer to be able to exclude from income the death benefit received means that there would no longer be a huge pool of former employees in whose lives the employer has a financial interest. Lastly, because the pool of employees that can be insured is limited to the highest paid 35 percent if the employer is to exclude the death benefits under the policies, the employer has no incentive to insure individuals who are not central to the operation of the business but may be lower paid, fungible workers whose life the employer has little incentive to protect. Due to these limitations on excludable death benefits under employer COLI, it is argued, there is no longer a need to resuscitate the 1999 President's budget proposal, which came shortly after the 1996 and 1997 legislative changes to interest deduction limitations (perhaps based on a perception that the 1996 and 1997 legislation had failed to stem the growth of COLI), but before the improvements made by the 2006 legislation. Similarly, some might argue that the 1999 proposal was previously rejected (or, certainly, not adopted) by Congress, and that it is not appropriate to continue to raise it.

On the other hand, it could be asserted that the 2006 improvements do not address the tax policy issue of tax arbitrage. The tax policy issue of COLI, it is argued, is the tax arbitrage opportunity it creates to deduct expenses such as interest with respect to tax-free inside buildup of life insurance contracts. The allowance of deductible expenses with respect to untaxed income is inconsistent with the concept of an income tax. While social policy benefits arise from the 2006 legislation limiting employer opportunities to collect death benefits on insured individuals whom the employer has no economic incentive to protect, it can be argued that the tax arbitrage effect of COLI remains to be addressed.

Proponents of the proposal also point out that the 2006 legislation may not serve as a practical limitation on the overall amount of COLI that any particular taxpayer acquires. Limiting the group of individuals that may be insured generally to 35 percent of the employer's workforce arguably creates an incentive to insure each covered individual for a larger amount than without such a limitation, but may have little impact on the overall face amount of life insurance that an employer can maintain on its books. Rather, as a practical matter, the face amount of life insurance of the employer is limited by the underwriting practices of the insurer. Thus, it is argued, the 2006 legislation has not slowed the growth of COLI. [801]

The proposal could be criticized on the grounds that it fails to take into account the concern that retaining an exception from the pro rata interest disallowance rule for employees, officers, and directors is important for small businesses. Small businesses might argue that they need access to cash, in particular the cash value of life insurance on key employees, and that it would be inappropriate to reduce the tax subsidy stemming from the exception in their case, regardless of the application of the proposal to others. A more targeted proposal, whether limited to financial intermediaries or to large employers, or alternatively a narrower employee

[801] A 2008 study shows that COLI held by banks grew to $126.1 billion in 2008, an increase of five percent from $120.1 billion in 2007. Darla Mercado, "Survey: Bank-owned life insurance assets hit $126B in '08," *Investment News.com* (June 23, 2009); see Ellen E. Schultz, "Banks Use Life Insurance to Fund Bonuses − Controversial Policies on Employees Pay for Executive Benefits, Help Companies With Taxes," *Wall Street Journal* (May 20, 2009), C1. The study referred to in the Mercado article does not account for COLI that may be held by financial institutions other than banks or by other types of businesses.

exception structured like the 20-key-person exception under the 1996 legislation, might address the tax arbitrage concern without negatively impacting the cash needs of small business.

On the other hand, it could be countered that in most cases the cash needs of small businesses have already been addressed by the proposal's continuation of the exception for 20-percent owners. In addition, it can be argued that insuring the lives of key employees can be accomplished by purchasing term life insurance, which is not affected by the proposal, and that cash needs arising from loss of a key employee can be addressed without the purchase of cash value life insurance. Further, because of the extension of the average person's expected life span in recent decades, it is argued that the purchase of term life insurance on a key employee through his or her likely retirement age is no longer difficult or expensive.

Opponents of the proposal argue that the funds borrowed under the life insurance contracts are used for tax-advantaged pre-funding of expenses such as retiree health benefits and supplemental pension benefits. Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits. It was not intended that tax arbitrage with respect to investments in COLI be used to circumvent statutory limits that Congress enacted for these tax-favored health and pension benefits, it is argued. Further, the assertion that particular sources of funds are used by corporations for particular expenses can be countered by pointing out that money is fungible.

A related argument is that COLI is accepted as tier 1 capital for banks, an important incentive for banks to hold COLI, and that limiting its tax advantages negatively impacts these financial institutions. Arguably, limiting this source of tier 1 capital may be a particularly inappropriate side effect of the proposal at the current time of economic downturn, illiquidity, unavailability of credit, and instability among some banks. Conceivably the proposal is inconsistent with efforts of the Federal government to stabilize and temporarily provide capital to the financial sector. On the other hand, it could be questioned whether a heavy investment in life insurance is a stabilizing influence on bank capital. Further, these nontax policy arguments could be criticized as unrelated to the tax policy issue addressed by the proposal.

Some might criticize the proposal as somewhat ineffective because it would not impose any dollar limitation on the amount of insurance an employer would be permitted to purchase with respect to a 20-percent owner, nor on the amount of interest expense allocable to unborrowed policy cash values with respect to such insurance that would remain deductible under the proposal. It could be argued that the proposal would not effectively deter undesirable tax arbitrage in many cases, without any such limitations.[802] On the other hand, it could be argued that State law concepts of insurable interest could operate as limits (but some might say these concepts would not impose any significant limit). It could also be argued that businesses with 20-percent owners might tend to be small businesses, and that encouraging the economic

[802] Some might go so far as to assert that, short of a rule that borrowing against life insurance value is a taxable receipt of the value borrowed, the tax arbitrage opportunity of tax-free inside buildup cannot be effectively addressed. Such a rule would be similar to section 956(c)(1)(C), for example, which provides that if a U.S. multinational borrows from its foreign subsidiary, the U.S. entity is subject to tax as if it had repatriated the (otherwise untaxed) foreign earnings.

success of small businesses is more important than limiting their tax arbitrage opportunities. Some might respond that a test based on the ownership percentage of shareholders is not actually targeted to small businesses, and that a more appropriate test would be focused on the assets or income of the business. Another response might be that 20-percent owners do not necessarily have any connection to the business, so the death of such a person might have no significant impact that would create a business need to insure the person's life. Further, it could be argued that any tax incentives provided to a sector of the economy, such as small business, should not be structured as arbitrage opportunities denied to other taxpayers, but rather as positive incentives towards socially or economically desirable goals.

Prior Action

A similar proposal was included in the President's fiscal year 1999, 2000, 2001, 2010, and 2011 budget proposals.

E. Miscellaneous Changes

1. Increase Oil Spill Liability Trust Fund financing rate by one cent

Present Law

The Oil Spill Liability Trust Fund is financed with revenues from an eight-cents-per-barrel[803] excise tax on crude oil received at a United States refinery and on imported petroleum products.[804] The tax rate is scheduled to increase to nine cents per barrel in calendar year 2017, after which it currently is scheduled to expire. A back-up "use tax" is imposed on crude oil that is used in or exported from the United States before being received at a refinery.[805]

The fund is used to pay costs related to oil spill removal activities, natural resource damage assessments and unpaid damages claims. Generally the liability of a party responsible for an oil spill is limited. There is liability for all removal costs but liability for other damages and costs is capped at $75 million. Money from the Fund may be used to pay such claims up to and beyond the responsible party's limit. There is a general limit of $1 billion per incident that may be paid out of the Oil Spill Liability Trust Fund, with costs of natural resource damage assessments and claims for any single incident limited to $500 million.

Description of Proposal

The proposal increases the excise tax to 9 cents per barrel after December 31, 2011, and to 10 cents per barrel after December 31, 2016.

Analysis

Initially, the excise tax was 5 cents per barrel and expired on December 31, 1994 because of a sunset provision in the law.[806] The Energy Policy Act of 2005[807] reinstated the excise tax and the Energy Improvement and Extension Act of 2008[808] increased the tax to 8 cents per barrel through December 31, 2016 and to 9 cents per barrel from then until December 31, 2017.

The Deepwater Horizon oil spill in the Gulf of Mexico was an unprecedented oil spill which raised questions about the adequacy of the present law liability and compensation framework. There are concerns that significant oil spills, such as Deepwater Horizon could

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[803] A barrel equals 42 gallons.

[804] Sec. 4611(a). Petroleum products include crude oil (sec. 4612(a)(3)). Statutorily, the tax also applies to domestic crude oil exported from the United States before being received at a U.S. refinery (sec. 4611(b)(1)).

[805] Sec. 4611(b).

[806] Sec. 4611(f)(1).

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

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

deplete the Fund leaving it diminished and insufficient for subsequent spills. As a result, an increase in the tax financing rate may ensure further stability of the Fund.[809] Opponents of an increase would argue that a better approach to ensuring the stability of the fund would be to increase the liability limits for the responsible parties rather than increase the tax rate. These opponents would argue that such a change would provide greater incentives for businesses to take steps to mitigate spill risks. While proponents of the tax increase would argue that the class of persons who create the risk of an oil spill should bear some responsibility for the adequacy of the Fund.

Prior Action

No prior action.

2. Permanent extension of Federal Unemployment Surtax

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent gross tax rate on the first $7,000 of wages for each calendar year paid by a covered employer to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through the first six months of 2011.

Description of Proposal

The proposal permanently extends the 0.2 percent surtax rate.

Effective date.−The proposal is effective as of the date of enactment.

Analysis

The proposal reflects the belief that a surtax extension is needed in order to increase funds for the Federal Unemployment Trust Fund to provide a cushion against future Trust Fund expenditures. The monies retained in the Federal Unemployment Account of the Federal

[809] The White House, "Fact Sheet: Deepwater Horizon Oil Spill Legislative Package," May 12, 2010.

Unemployment Trust Fund can then be used to make loans to the 53 State Unemployment Compensation benefit accounts as needed.

As a tax on labor, the FUTA tax is thought to be borne by labor in the long run in the form of lower wages, rather than borne by the employers, who have the statutory obligation to pay the tax. Though the economic incidence of the tax falls on labor, so too do the benefits, in the form of unemployment compensation paid during future periods of unemployment.

Prior Action

A similar provision was included in the President's fiscal year 2011 budget proposal.

3. Provide short-term tax-relief to employers and expand Federal Unemployment Tax Act base

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. States that become non-compliant experience a reduction in FUTA credit, causing employers to face a higher Federal unemployment insurance tax. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

Each State also imposes an unemployment insurance tax on employers to fund its State unemployment insurance trust fund. State unemployment insurance trust funds are used to pay unemployment benefits. When State trust funds are exhausted, States borrow from the Federal UI trust fund to pay for unemployment benefits. States that borrow from the Federal UI trust fund are required to pay back the borrowed amount including interest. This debt is partly repaid by increases in the Federal unemployment insurance tax (reductions in the credit) on employers in these States.

The Federal Unemployment Trust Fund has 59 accounts. The accounts consist of 53 State Unemployment Compensation ("UC") benefit accounts, the Railroad Unemployment Insurance Account, the Railroad Administration Account, and four Federal accounts. The Federal unified budget accounts for all Federal-State UC outlays and taxes in the Federal Unemployment Trust Fund.

The four Federal accounts in the trust funds are: (1) the Employment Security Administration Account ("ESAA"), which funds administration; (2) the Extended Unemployment Compensation Account ("EUCA"), which funds the Federal half of the Federal-State Extended Benefits Program; (3) the Federal Unemployment Account ("FUA"), which funds loans to insolvent State UC Programs; and (4) the Federal Employees' Compensation

Account ("FECA"), which funds benefits for Federal civilian and military personnel authorized under 5 U.S.C. 85. The 0.8 percent Federal share of the unemployment tax finances the ESAA, EUCA, and FUA, but general revenues finance the FECA. Interest-bearing loans are allowed to ESAA, EUCA, and FUA from the general fund. The three accounts may receive noninterest-bearing advances from one another to avoid insufficiencies.

Description of Proposal

The proposal suspends interest payments on State unemployment insurance debt and the FUTA credit reduction for employers in borrowing States in 2011 and 2012. The proposal also raises the FUTA wage base to $15,000 per worker paid annually beginning in 2014, indexes the wage base to wage growth for subsequent years, and reduces the net Federal unemployment insurance tax from 0.8 percent to 0.38 percent.

Effective date.−The proposal is effective as of the date of enactment.

Analysis

The proposal provides short-term relief to those States that have borrowed from the Federal trust funds by suspending interest payments and the FUTA credit reduction. By providing short-term relief, the proposal forestalls immediate tax increases on employers as a result of reductions in the FUTA credit or in increases in unemployment insurance taxes that could be imposed by States in order to repay loans taken from the Federal trust funds. The short term relief could thus prevent immediate tax increases on employers that could be detrimental to employment. However, the State borrowings must ultimately be repaid, and State unemployment insurance tax rate increases could be necessary if job growth alone does not produce sufficient revenue for the State trust funds.

The proposal also roughly doubles the wage base of the FUTA tax, from $7,000 to $15,000 (approximately the annual wages of a full time minimum wage worker), and roughly halves the FUTA tax from 0.8 percent (after the proposed permanent extension of the FUTA surtax) to 0.38 percent. The proposal also indexes the wage base to wage growth. The immediate changes to the wage base and the rate would yield the same tax obligation for an employer of an employee earning $14,737 ($14,737 times 0.38 percent equals $56 and $7,000 times 0.8 percent equals $56). For employees earning less than $14,737, the tax obligation of the employer would fall, while for those with employees earning $15,000 or more the tax obligation would rise to $57. Over time the tax obligations for most employers would increase relative to the present tax rate and base as a result of the indexation of the wage base to wage growth. This increase in revenues would help shore up State trust funds, but could have some negative consequences for employment in the short-term term by raising the tax cost of hiring new employees, and by reducing employees' after-tax wages in the long term.

Prior Action

No prior action.

4. Expand Short-Time Compensation ("STC") Unemployment Program

Present Law

The Short-Time Compensation ("STC") unemployment program, also known as work sharing, is a program within the Federal-State unemployment compensation system that provides pro-rated unemployment benefits to workers whose hours are reduced in lieu of a layoff.

Description of Proposal

The proposal would implement a two-year Federal STC program for States without existing STC programs. The Federal STC program would provide up to 26 weeks of benefits per year and fund 50 percent of STC benefits. Employers would fund the remaining 50 percent by reimbursing state trust funds for benefit payments but would not face changes in UI experience rating as a result of participating. Employers with regular seasonal and/or temporary layoffs and employers who reduced their workforces by more than 20 percent in the previous three months would be ineligible.

The proposal would also provide three incentives for States to enact permanent STC programs. First, a state would receive full Federal funding for benefit payments for up to three years after enactment of a State program. Second, the proposal would also distribute incentive payments to States from a pool of $700 million. Incentive payments would be disbursed in increments into a State's UI trust fund and would be calculated based on a State's share of Federal taxable wages. Third, the proposal would also provide a one-time start-up grant to States that pass the STC program into law. Finally, the proposal would fund a work-sharing marketing campaign to promote State adoption of STC and employer participation.

The proposal would also clarify the STC definition and legal authorization.

Effective date.−The proposal is effective as of the date of enactment.

Analysis

Some employers use STC and work sharing arrangements to reduce labor costs, sustain morale, and retain workers. STC programs may reduce or eliminate the need to recruit new employees when business improves. For employees, work sharing spreads earnings reductions across more employees as opposed to imposing significant hardship on a few.

Currently, only 20 States operate STC programs to support work sharing arrangements. Three of the 20 STC states - Colorado, New Hampshire, and Oklahoma- enacted their STC programs in 2010. Through the end of 2008, the STC program barely exceeded 1 percent of unemployment benefits paid annually across the United States. The STC program accounted for 2 percent of unemployment insurance benefits in 2009 and 1.2 percent in 2010.

The Administration's proposal reflects the belief that a temporary Federal STC program would encourage expansion of State STC programs and would also help relieve pressure on State unemployment trust funds during the current recession. The Federal government would temporarily fund STC in States that operate STC programs and would also provide Federal

monies to help States administer the increased number of participating employers and beneficiaries. Some argue that such work sharing can provide macroeconomic benefits to a State by preserving jobs during cyclical downturns, maintaining consumption through continued wages, and ensuring the continuation of employer-sponsored health insurance and pensions, thereby reducing reliance on State-provided services and supports.

The administrative costs of STC programs have been a concern for State labor agencies. In many States, STC is still paper-based and States approve employers' work sharing plans on a case-by-case basis.

Prior Action

No prior action.

5. Repeal last-in, first-out inventory accounting method

Present Law

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[810]

Under the last-in, first-out ("LIFO") method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[811] Compared to first-in, first-out ("FIFO"), LIFO produces net income which more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory is generally not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which sales exceed purchases.[812]

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[810] Sec. 471(a) and Treas. Reg. sec. 1.471-1.

[811] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year. Sec. 472(b).

[812] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (and inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

Dollar-value LIFO

Under a variation of the LIFO method, known as dollar-value LIFO, inventory is measured not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the "pooling" of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer's method for defining an item, LIFO can be applied to a taxpayer's entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.[813] In doing so, the Congress acknowledged that the LIFO method is generally considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.[814]

To qualify for the simplified method, a taxpayer must have average annual gross receipts of $5 million or less for the three preceding taxable years.[815] Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

Special rules for qualified liquidations of LIFO inventories

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 of the Code mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

Description of Proposal

The proposal repeals the LIFO inventory accounting method. Taxpayers that currently use LIFO would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2012. The resulting increase in income is taken

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[813] Sec. 474(a).

[814] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)*, (JCS-10-87), May 4, 1987, p. 482.

[815] Sec. 474(c).

into account ratably over 10 taxable years beginning with the first taxable year beginning after December 31, 2012.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2012.

Analysis

In general, assuming rising prices, taxpayers using LIFO have an incentive to maintain or build inventory levels rather than allowing them to fall. So long as inventory levels are steady or growing the taxpayer never is deemed to have sold any of its older, lower-cost inventory, and inflationary gain is deferred indefinitely. However, in a period in which the inventory level falls, the taxpayer necessarily will (absent a special rule) be deemed to have sold some units purchased in a prior period, and the inflationary gain in those periods will be recognized in taxable income.[816]

Proponents of the LIFO method argue that in periods of rising costs, the method provides the most accurate reflection of current-period economic income because it matches current costs against current sales revenues. They point out that the taxpayer will have to replace the inventory to continue in business and that by including the most recent additions to the inventory in cost of goods sold, the required cost of replacing the inventory is more closely projected.[817]

Alternatively, proponents of the FIFO method argue that LIFO permits deferral of inflationary gains in a taxpayer's inventory even when those gains arguably have been realized by the business. They note that outside of the inventory context, inflationary gains are generally taxed when the gain is realized (i.e., upon sale of the appreciated asset) and LIFO offers self-help against inflation that is not available in other contexts. FIFO proponents further assert that the use of earlier acquired items to value ending inventory understates net worth in times of rising prices resulting in an understatement of the income that measures the change in net worth for a given period.[818]

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[816] By contrast, inflationary gain is generally recognized in earlier periods under the FIFO method, so taxpayers using FIFO do not have a similar incentive to maintain or build inventory levels.

[817] See, e.g., LIFO Coalition letter to then-Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 Tax Notes Today 125-18), wherein author Leslie J. Schneider explains that, "If a business is faced with the situation that, because of inflation, each time that it sells any item from its inventory, it must expend a larger amount of capital than the FIFO cost of the item to simply replace the item of inventory that has been sold, the business would continually be required to increase its capital investment in inventory to simply maintain the status quo. Presumably, this increased capital investment would ordinarily be financed from the proceeds of the sale of the inventory, but if that profit were taxed on a FIFO basis, the after-tax proceeds from the sale of the inventory would in many cases not be sufficient to finance the acquisition of the necessary replacement inventory."

[818] Commentators favoring FIFO have also noted that since ending inventory under LIFO can be controlled through the purchase of additional units at year-end, LIFO is susceptible to manipulation by taxpayers through timing year-end purchases or sales of inventory. See, e.g., Testimony of George A. Plesko before the Committee on Finance United States Senate, June 13, 2006. However, proponents of LIFO point out that court decisions and IRS

Proponents of FIFO also argue that a business whose inventory turns over with regularity during a taxable year should not value inventory as if it includes items purchased in prior years. However, LIFO advocates counter that, although there may be inventory turnover, it is highly unlikely that there is a time when there are no units in inventory. They view this perpetual inventory "layer" as a required condition of doing business and best valued at the time the layer was established, which is accomplished under LIFO. Thus, supporters of LIFO argue that during inflationary periods, using LIFO enables a business to finance its increasing need for capital to maintain physical inventory levels. In this respect, they note that LIFO functions much like accelerated depreciation for capital investment in productive machinery and equipment.[819]

Commentators contend that LIFO and, more specifically dollar-value LIFO (the most commonly used method of valuing inventory under LIFO), does not simply isolate changes in inventory cost resulting from inflation, but includes increases and decreases due to other factors outside of normal inflation such as changes in technology and changes in relative values as market supply and demand changes.[820] These commentators also note that a taxpayer's definition of an "item" for purposes of establishing its dollar-value LIFO pools can result in changes to inventory costs that are not attributable solely to inflation.[821] For example, a broad item definition generally results in fewer pools lessening the likelihood that a previously established LIFO layer will be liquidated, which has the effect of deferring gain which results not from inflation, but from a change in the goods that comprise a particular dollar-value LIFO pool.

Supporters of LIFO have also pointed out the potential adverse economic effects of the recapture of the LIFO reserve, especially for those businesses that have used LIFO for decades. The tax imposed on the recapture of the reserve, even where the recapture is spread over a period of years (e.g., ten as is currently proposed), could be substantial, and could severely restrict the ability of such taxpayers to invest in capital, including maintaining their current physical inventory levels.[822]

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rulings effectively preclude taxpayers from acquiring unneeded inventory at year end to avoid liquidation of low-cost LIFO layers. See, LIFO Coalition letter to Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 Tax Notes Today 125-18).

[819] LIFO Coalition letter to then-Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18). See also, Alan D. Viard, "Why LIFO Repeal is Not the Way to Go," *Tax Notes* (November 6, 2006), p. 574.

[820] See Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, "Is it Time to Liquidate LIFO?" *Tax Notes* (October 16, 2006), p. 237.

[821] *Ibid.*

[822] See, e.g., Small Business Administration: Office of Advocacy letter to the Tax Reform Subcommittee of the Presidential Economic Recovery Advisory Board dated September 29, 2009, noting that "eliminating the ability to use LIFO would result in a tax increase for small business that could ultimately force many small businesses to close," http://www.sba.gov/advo/laws/comments/tax09_0929.html.

Unlike U.S. Generally Accepted Accounting Principles ("GAAP"), international financial reporting standards ("IFRS") do not treat LIFO as a permitted method of accounting.[823] The Securities and Exchange Commission ("SEC") recently indicated its support for global accounting standards and it continues to work toward making a determination by 2011 as to whether to incorporate IFRS into the U.S. financial reporting system. SEC staff also noted that if the SEC were to decide to move to IFRS, the transition date for U.S. issuers would be no earlier than 2015.[824] The seemingly inevitable shift from GAAP to IFRS raises the issue of whether companies will be able to continue using LIFO for tax purposes in light of the conformity requirement.[825]

Prior Action

A similar proposal for the repeal of LIFO was included in the President's budget proposal for fiscal years 2010 and 2011.

6. Repeal gain limitation on dividends received in reorganization exchanges

Present Law

Distributions and stock redemptions in general

If a corporation distributes cash (or other property not permitted to be received without tax)[826] to its shareholders who do not surrender stock in a redemption, the distribution is generally treated as a dividend to the shareholders, to the extent of the corporation's current and accumulated earnings and profits.[827] Amounts in excess of such earnings and profits are treated

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The potentially adverse effect of the repeal of LIFO could be moderated by modifying the LIFO reserve recapture, for example, specifying partial reserve recapture based on business size or other mitigating factors, or extending the spread period for recapturing the LIFO reserve.

[823] International Accounting Standards Board, International Accounting Standard (IAS) No. 2, *Inventories*, (rev. 2003).

[824] See February 24, 2010, remarks of SEC Chair Mary Shapiro and SEC Chief Accountant James Kroeker (2010 TNT 37-6). Previously, the SEC had proposed full adoption of IFRS by large U.S. companies by 2014. See RIN 3235-AJ93, 73 Fed. Reg. 70816 (November 21, 2008).

[825] Some commentators have noted that the conformity requirement is a requirement "in form only" because changes to the regulations allow alternative inventory valuations be disclosed in the financial statements provided the face of the income statement reflects LIFO. See Michael J. R. Hoffman and Karen S. McKenzie, "Must LIFO Go to Make Way for IFRS?" *The Tax Adviser* (March 2009).

[826] Certain distributions of stock to shareholders with respect to a corporation's stock are permitted to be received tax free (sec. 305) as are certain distributions of stock, or of securities to the extent of securities surrendered, in tax free reorganizations or section 355 divisive transactions. Section 351 contains rules permitting the tax-free receipt of certain stock in exchange for property contributed to a corporation.

[827] Sec. 301.

as recovery of a shareholder's stock basis, and then as capital gain to the extent in excess of such basis.

If a corporation redeems its stock and one of four tests is satisfied, the redeemed shareholder treats the redemption as a sale or exchange.[828] This allows the shareholder to reduce the amount included in income by his basis in the redeemed stock and also entitles the shareholder to capital gain (or loss) treatment. If none of the tests is met, the redemption is treated as a dividend to the extent that the distribution is either out of accumulated earnings and profits or out of earnings and profits for the current year.

The four tests are: (1) the redemption is not essentially equivalent to a dividend; (2) the distribution is substantially disproportionate with respect to the shareholder (i.e., the shareholder's ownership of voting stock and common stock declines by more than 20 percent as a result of the redemption and the shareholder owns less than 50 percent of the voting stock after the redemption); (3) the shareholder's interest is completely terminated; and (4) a shareholder (other than a corporation) is redeemed in partial liquidation of the distributing corporation.

Whether dividend treatment or sale treatment is more advantageous to the recipient depends upon the recipient's tax situation. Dividend treatment (outside of the special rules applicable in a corporate reorganization, discussed later below) does not allow a shareholder to limit its income by the benefit of any stock basis recovery. However, dividend treatment can be advantageous to a corporate shareholder, depending upon the circumstances, because in the domestic context a corporate recipient generally would be entitled to a dividends-received deduction of at least 70 percent, and possibly all, of the amount of the dividend, depending on stock ownership[829] (or would eliminate the dividend if it is filing a consolidated return with the payor).[830] If the recipient is a foreign person and the payor is a domestic corporation, dividends are generally subject to withholding tax, a result generally less favorable than non-taxed capital gain treatment from a stock redemption treated as a sale of the stock. However, the amount of withholding tax on dividends is reduced under many treaties. If the payor is a foreign corporation, U.S. shareholders may be entitled to foreign tax credits with respect to a dividend. On the other hand, if basis is allowed to offset the amount of income from the distribution, then the transfer of stock with a high basis for cash or other property may be largely or entirely nontaxable.

The earnings and profits of a corporation paying a distribution that is a dividend are reduced by the entire amount of the dividend. If a distribution in redemption of stock is treated as a sale or exchange, then the amount of the distribution properly chargeable to earnings and

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[828] Sec. 302.

[829] Sec. 243.

[830] Treas. Reg. sec. 1.1502-13(f).

profits is limited to the ratable share of the earnings and profits attributable to the redeemed stock.[831]

Section 304

Under section 304(a)(1), if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation (the "target") from the person (or persons) so in control, then for purposes of section 302 and 303, the property shall be treated as a distribution in redemption of the stock of the acquiring corporation. The tests described above to determine the tax treatment of a stock redemption apply to determine whether the transfer is treated as an exchange or as a distribution of property. To the extent the deemed property distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated in the same manner as if (1) the transferor had transferred the acquired stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then transferred the property to the transferor in redemption of the stock it is deemed as having issued.[832] In the case of a section 304 transaction, both the amount and source of any dividend are determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the target (i.e., issuing) corporation to the extent of its earnings and profits.[833]

Special rules apply if the acquiring corporation in a section 304 transaction is a foreign corporation.[834] The foreign acquiring corporation's earnings and profits that are taken into account to determine the amount and source of a dividend are limited to the portion of such earnings and profits that (1) are attributable to stock of the foreign acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) of the target corporation and who is a U.S. shareholder (within the meaning of section 951(b)) of the foreign acquiring corporation and (2) were accumulated while such stock was owned by the transferor (or a person related thereto) and while the foreign acquiring corporation was a controlled foreign corporation ("CFC").

Boot in reorganizations and certain 355 distributions

In general, gain or loss is not recognized with respect to exchanges of stock and securities by a shareholder in corporate reorganizations (or section 355 divisive stock distributions). However, if such an exchange also involves the receipt of nonqualifying consideration ("boot"), then the shareholder must recognize gain (if any) to the extent of the boot received in the

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[831] Sec. 312(n)(7).

[832] Sec. 304(a)(1).

[833] Sec. 304(b)(2).

[834] Sec. 304(b)(5).

exchange. No loss is allowed.[835] Further, part or all of that gain may be taxable as a dividend if the exchange has the effect of a distribution of a dividend. Unlike the rules that apply to ordinary dividends, under the boot dividend rules of section 356(a)(1), the amount of a dividend recognized by the exchanging shareholder is limited to the amount of gain recognized by the shareholder on the exchange. Also, under the boot dividend rules, a shareholder's dividend income recognized is limited to "such an amount of the gain recognized as is not in excess of his ratable share of undistributed earnings and profits of the corporation accumulated after February 28, 1913."[836] The remainder of the gain recognized, if any, is treated as gain from the exchange of property.

The courts and the IRS have held that the principles developed in interpreting the rules relating to stock redemptions are applicable in determining whether boot received in a reorganization exchange or a section 355 exchange is treated as a dividend. In *Clark v. Commissioner*,[837] the Supreme Court explicitly applied the substantially disproportionate test of the stock redemption rules in the reorganization context by analyzing whether the distribution is substantially disproportionate with respect to the shareholder (i.e., the shareholder's ownership of voting stock and common stock declines by more than 20 percent as a result of the redemption and the shareholder owns less than 50 percent of the voting stock after the redemption). This test was applied by treating the boot as being paid in redemption of additional stock hypothetically received by the exchanging shareholder and applying the tests under section 302. Nevertheless, there is no explicit statutory coordination between the stock redemption rules and the rules relating to the treatment of boot received in a reorganization exchange or a section 355 exchange.

As discussed above, under section 356(a) boot will only be treated as a dividend to the extent of the exchanging shareholder's ratable share of the corporation's undistributed earnings and profits. The IRS has ruled, and at least one circuit court has held under present law that, for purposes of determining the deemed dividend under section 356(a)(2), the earnings and profits of the target (i.e., transferor) and the acquiring (i.e., transferee) corporation should both be taken into account when the corporations are commonly owned.[838] Other courts, however, have held that only the earnings and profits of the target corporation are taken into account even in the case of common ownership.[839]

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[835] Sec. 356(c).

[836] Section 356(a)(2). Courts have interpreted a reference to earnings and profits accumulated to include current earnings and profits for the year of the distribution. See, e.g., *James Armour, Inc. v Commissioner*, 43 T.C. 295 (1965); *Weaver v. Commissioner*, 25 T.C. 1067 (1956); *Vesper Co. v. Commissioner*, 131 F. 2d 200 (8th Cir. 1942). The scope of the latter two cases as applied to section 356(a)(2), and the application of the ratable share language under that section, are potentially unclear.

[837] 489 U.S. 726 (1989).

[838] Rev. Rul. 70-240, 1970-1 C.B. 81; *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied 386 U.S. 1022 (1967).

[839] *American Mfg. Co. v. Commissioner,* 55 T.C. 204 (1970); *Atlas Tool Co. v. Commissioner*, 70 T.C. 86 (1978), aff'd 614 F.2d 860 (3d Cir. 1980), cert. denied 449 U.S. 386 (1980).

If an exchange described in section 356(a)(1) has the effect of a distribution of a dividend, the earnings and profits from which it is considered to be paid are reduced by the entire amount that is taxable as a dividend to the shareholder. In a ruling issued prior to the enactment of section 312(n)(7), which limits the reduction of earnings and profits in a section 302 redemption to the ratable share attributable to the redeemed stock, the IRS ruled that in a dividend equivalent transaction under section 356(a)(2), earnings and profits are also reduced by the amount that exceeds the shareholder's ratable share of earnings and profits and that is taxed to the shareholder as capital gain.[840] There is a lack of clarity under present law whether the limitation on the reduction of earnings and profits under section 312(n)(7) applies in the case of a reorganization.

Some reorganizations (under sections 368(a)(1)(D),[841] (E),[842] and (F)[843]) necessarily involve corporations under common control, or a single corporation. Other reorganizations also may involve continuing common ownership such that as to a particular shareholder, boot received may be treated as a dividend.

Certain cross-border reorganizations under section 367

In general, to the extent that transactions include certain cross-border transfers, the provisions of section 367(a) and (b) apply to (i) preserve the U.S. ability to tax gains attributable to the accrued appreciation in assets that leave the U.S. tax system and (ii) require the inclusion of previously untaxed foreign earnings of certain foreign subsidiaries (hereinafter the "earnings repatriation purpose").[844] Thus, section 367(a)(1) provides that if, in connection with certain exchanges under subchapter C of the Code, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which

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[840] Rev. Rul. 72-327, 1972-2 C.B. 197.

[841] The transfer of assets by a transferor corporation to another corporation, controlled (immediately after the transfer) by the transferor or one or more of its shareholders, will qualify as a tax-free reorganization under section 368(a)(1)(D) if certain requirements are met. These requirements generally are that (1) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor corporation followed by, in effect, a complete liquidation of the transferor corporation, or (2) the transfer is made by one corporation of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation, followed by the distribution of the stock and securities of the controlled subsidiary in a divisive spin-off, split-off, or split-up which was not used principally as a device for the distribution of earnings and profits.

If, pursuant to an integrated plan, a parent corporation sells the stock of a subsidiary to another subsidiary and the acquired subsidiary liquidates into the acquiring subsidiary, the transaction is a tax-free reorganization. Rev. Rul. 2004-83, 2004-2 C.B. 157. This holds true, whether or not there is an actual issuance of stock, to the extent the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions. Treas. Reg. sec. 1.368-2(l) (see T.D. 9475, 2010-4 I.R. B. 304).

[842] Section 368(a)(1)(E) refers to a recapitalization.

[843] Section 368(a)(1)(F) refers to a mere change in identity, form, or place of organization of one corporation, however effected.

[844] H.R. Rep. No. 94-658 (Nov. 12, 1975).

gain shall be recognized on such transfer, be considered a corporation.[845] By deeming the foreign corporation not to be a corporation, the provision precludes the transfer from qualifying as tax-free under subchapter C. The Secretary has broad regulatory authority under section 367(a)(2), (3) and (6) to provide that section 367(a)(1) will or will not apply to certain transfers described therein.

Section 367(b) applies to certain exchanges in which there is no transfer of property described in section 367(a)(1).[846] Section 367(b)(1) provides that a foreign corporation shall be considered to be a corporation, except to the extent provided in regulations in order to prevent the avoidance of Federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing, among other things, the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

In recent years, Treasury has focused on certain transaction structures that are inconsistent with section 367(a) and (b). Two recent examples include the transactions commonly referred to as "Killer B" transactions and transactions referred to as "Deadly D" transactions.[847]

"Killer B" guidance

Notices 2006-85 and 2007-48 and temporary Treasury regulations subsequently issued under section 367(b)[848] apply to certain triangular reorganizations[849] involving a parent

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[845] The exchanges described under the general rule of section 367(a)(1) include: (1) complete liquidations of subsidiaries under section 332; (2) transfers to controlled corporations under section 351; (3) exchanges of stock and securities in certain reorganizations under section 354; (4) the distribution of stock and securities of a controlled corporation under section 355; (5) the receipt of additional consideration under section 356; and (6) the rules regarding the nonrecognition of gain or loss to corporations as well as the treatment of certain distributions under section 361.

[846] Sec. 367(b)(1). Specifically, section 367(b) applies to an exchange described in sections 332, 351, 354, 355, 356 or 361 in connection with which there is no transfer of property described in section 367(a)(1).

[847] The names "Killer B" and "Deadly D" reflect the fact that the original transactions targeted by the guidance were reorganization transactions under sections 368(a)(1)(B) and 368(a)(1)(D), respectively. The guidance applies, however, to a broader range of transactions designed to qualify as tax free reorganizations. In addition to issuing guidance on these transactions, temporary regulations were also issued under Treas. Reg. sec. 1.956-1T(e)(6) to address a repatriation transaction where the domestic corporation makes an outbound transfer of its stock or obligations to a CFC in exchange for consideration consisting of CFC stock but primarily cash. Taxpayers had taken the position that the transfer did not trigger a gain or dividend inclusion under Section 1032(a) and that the CFC's ownership of the domestic corporations stock or obligations would not result in section 956 inclusions for the U.S. shareholders of the CFC since the CFC took a zero basis in the transferred stock or obligations pursuant to Section 362(a). The temporary regulation provides that, solely for purposes of Section 956, the basis of the stock or obligation in the hands of the CFC will be equal to its fair market value. As discussed in the Treasury Decision preamble, this temporary regulation was issued under the authority of sections 956(e) and 367(b).

[848] Notice 2006-85, 2006-2 C.B. 677; Notice 2007-48, 2007-1 C.B. 1428; Treas. Reg. sec. 1.367(b)-14T.

corporation ("parent") and subsidiary corporation ("subsidiary"), at least one of which is foreign. Pursuant to the reorganization, the subsidiary acquires from the parent, in exchange for property, parent stock that is then used by the subsidiary to acquire the stock or assets of a target corporation ("target") (which may be related or unrelated to the parent and the subsidiary before the transaction) in a tax-free reorganization. Prior to the guidance, taxpayers took the position that no gain or loss was recognized on the exchange of parent stock for property under section 1032 and the regulations thereunder, even if the subsidiary acquired the parent stock for cash or a note and had significant previously untaxed earnings and profits. In general, section 1032(a) provides that a corporation will not recognize any gain or loss to the extent it receives any money or other property in exchange for its own stock. To prevent the use of such transactions to inappropriately repatriate previously untaxed earnings without an income inclusion, the regulations provide that the transfer of property by the subsidiary to the parent in exchange for the parent stock shall be treated as a transaction separate from, and occurring immediately before, the triangular reorganization. Therefore, the parent shall not be treated as receiving the property from the subsidiary in exchange for the parent stock and the separate distribution is subject to section 301.[850]

"Deadly D" guidance

Notice 2008-10 and recently issued proposed regulations under section 367(a)(5)[851] address certain transactions designed to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion, in certain authorized reorganizations, by virtue of the application of the basis adjustment rule of section 367(a)(5).[852] The notice describes a fact pattern in which the U.S. parent ("USP"), wholly owns a foreign acquiring corporation ("FA"), and USP's basis in its FA stock is $100. USP also wholly owns U.S. target ("UST"), and USP's basis in its UST stock equals its fair market value of $100. UST owns property with zero tax basis such as self-created intangibles and fully depreciated tangible property. UST sells its property to FA in exchange for $100 cash and, in connection with the transaction, UST liquidates. FA then transfers all of the property acquired from UST to a U.S. Newco ("USN"), a newly formed U.S. domestic corporation, in exchange for 100 percent of the USN stock.

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[849] A "triangular reorganization" includes a forward triangular merger, a triangular C reorganization, a reverse triangular merger, or a triangular B reorganization under Treas. reg. sec. 1.358-6(b)(2)(i) through (iv), or a reorganization described in section 368(a)(1)(G) and (a)(2)(D).

[850] In general, section 301(c) provides that any applicable distribution will first be treated as a dividend to the extent of earnings and profits, then as a reduction in the adjusted basis of such stock, and any excess will be treated as gain from the sale or exchange or property.

[851] Notice 2008-10, 2008-3 I.R.B. 277; Prop. Treas. Reg. sec. 1.367(a)-7.

[852] Sec. 367(a)(5) generally provides that a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange will result in gain recognition to the transferor. It then, however, provides that, in lieu of such gain recognition, regulations will provide for certain basis adjustments if the U.S. transferor is controlled (within the meaning of section 368(c)) by five or fewer domestic corporations.

In this and similar fact patterns, taxpayers took the position that the transfer of property by UST to FA was not subject to gain recognition under section 367(a) or (d), because the basis adjustment rule of 367(a)(5) allowed USP to reduce by $100 its basis in the FA stock that it held immediately prior to the transaction.[853] The result of this position was that USP was effectively able to repatriate FA's previously untaxed earnings and profits with little or no U.S. taxation. Notice 2008-10, however, provided that the basis adjustment rule of section 367(a)(5) could not be applied to the stock of FA held by USP immediately prior to the transaction, so that, under the facts within this notice, the transfer of property by UST to FA was subject to the gain recognition provisions of sections 367(a) and (d).

The preamble to the proposed regulations issued under section 367(a)(5) announced that the IRS and Treasury Department were considering whether the gain limitation rule of Section 356(a)(1) should apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that section 367(b) is intended to protect against U.S. tax avoidance upon the repatriation of previously untaxed foreign earnings. The preamble requested comments in this regard, including whether any guidance should apply only to cases in which section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property (i.e., if the exchange has the effect of a distribution of a dividend).[854] Some comments have been received, but no further action has been taken to date.

Description of Proposal

The proposal repeals the boot-within-gain limitation of current law in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).

Effective date.–The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

Present law allows significant flexibility to structure distributions of cash or other property to shareholders as dividends in full, or as dividends limited by stock gain, depending upon whether or not the transaction is structured as a reorganization. Furthermore, because of the lack of certainty regarding the earnings and profits that would support dividend treatment in a reorganization (whether those of both the acquiring and acquired corporation or rather only those of the acquired corporation) and because of other uncertain or different rules for reorganization

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[853] In taking this position, taxpayers apparently relied upon the legislative history of section 367(a)(5), which provided that the regulations were expected to provide relief from the general rule only if the "U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation." S. Rep. No. 100-455, p. 62 (August 3, 1988).

[854] REG-209006-89, 73 Fed. Reg. 49,277 (August 20, 2008) as corrected by REG-209006-89, 73 Fed. Reg. 56,535 (September 29, 2008).

dividends compared to non-reorganization dividends (such as whether there is a dividend to the extent of accumulated earnings and profits only, or also including current earnings and profits for reorganizations, compared to the use of both current and accumulated earnings and profits outside of a reorganization), taxpayers may have significant flexibility as to the extent to which they report a distribution as a dividend on the one hand, or as a recovery of basis and capital gain on the other hand.

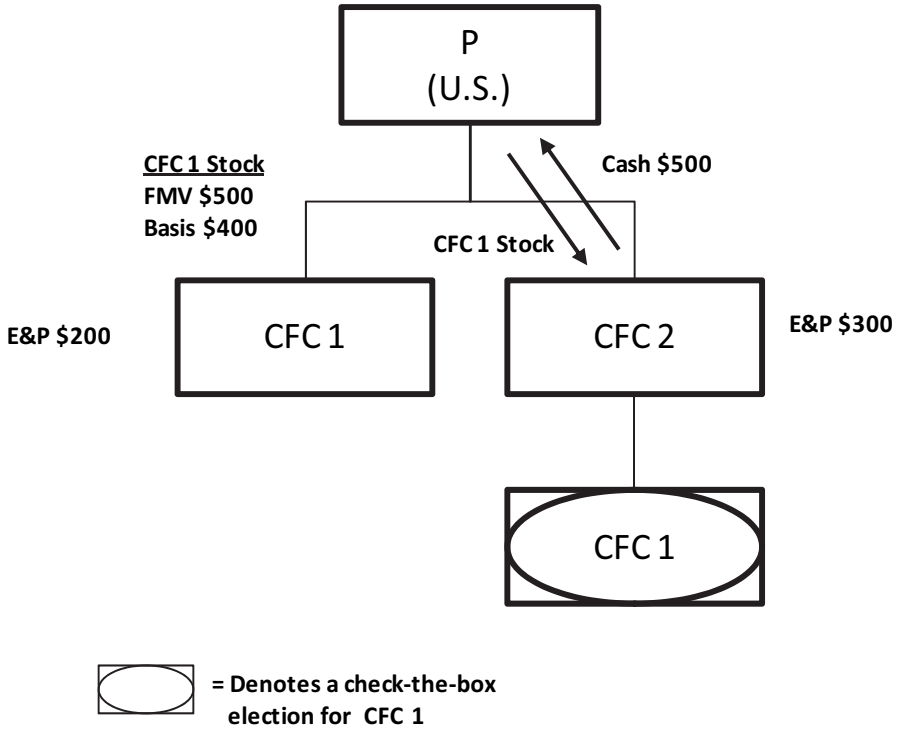
The transaction identified by the Administration's proposal

In cross-border reorganizations, the boot-within-gain limitation under section 356(a)(2) can permit U.S. shareholders to repatriate property from their foreign subsidiaries with minimal or no U.S. tax consequences, even if the foreign subsidiaries have sufficient untaxed earnings and profits to treat the repatriated property as a dividend. To the extent the exchanging shareholder's stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the acquiring corporation has previously untaxed earnings and profits equal to or greater than the amount of the boot.

The check-the-box regulations have enabled taxpayers more easily to avail themselves of this strategy. Making a check-the-box election to treat the target corporation as an entity disregarded as separate from the owner can convert what would otherwise have been a transfer taxable under section 304(a)(1) into an asset reorganization in which the taxable amount is limited under the boot-within-gain rule of section 356(a).

For example, assume that P, a U.S. domestic corporation, wholly owns CFC 1 and CFC 2. P's shares in CFC 1 have a tax basis of $400 and a FMV of $500. CFC 1 and CFC 2 each have previously untaxed E&P of $200 and $300, respectively. Assume CFC 2 purchases the shares of CFC 1 from P for $500 cash. If a check-the-box election is made to treat CFC 1 as a disregarded entity pursuant to the same plan in which CFC 1 is transferred to CFC 2 and if the other requirements for a reorganization are satisfied,[855] the transaction is treated as a cross-border reorganization to which the boot-within-gain rule applies to limit taxable gain to $100 ($500 FMV less $400 tax basis). If a check-the-box election were not made for CFC 1, or CFC 1 were not otherwise liquidated, section 304(a)(1) would apply to the transaction and the $500 in cash would be treated as a dividend to the extent of the previously untaxed E&P of CFC 2 ($300) and then CFC 1 ($200). The example is illustrated below.

[855] Reorganization treatment is generally subject to certain requirements, including business purpose, continuity of interest, and continuity of business enterprise.



As illustrated above, in a transaction involving commonly-owned corporations, a taxpayer with nonpreviously taxed E&P in its CFCs may, at its option, prevent application of the section 304 requirement of full dividend inclusion to the extent of earnings and profits, and instead invoke the boot-within-gain limitation under section 356(a)(2), by choosing to liquidate the target corporation as part of the transfer. Therefore, eliminating the application of the boot-within-gain limitation in the case of any reorganization in which there is a foreign acquirer and in which the exchange has the effect of distribution of a dividend under section 356(a)(2) is consistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation. It has been suggested that under present law, any previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule may, in certain circumstances, be preserved for future taxation.[856]

[856] However, as previously noted, there is a lack of clarity under present law whether the limitation on the reduction of earnings and profits under section 312(n)(7) applies in the case of a reorganization. Some have urged that taxpayers may take the position, based on Rev. Rul. 72-327, *supra*, that earnings and profits of the target corporation are reduced by the entire amount of boot in a reorganization, even to the extent not treated as a dividend to the shareholder. See Jasper L. Cummings, Jr., "Corporate E&P and Reorganization Boot," *Tax Notes* (March 29, 2010), pp.1635, 1642. To the extent earnings and profits are reduced under this view, they would not be preserved at the target corporation level.

Comments provided to Treasury responding to preamble in proposed regulations

The limited comments provided to Treasury in response to its announcement in the preamble to the proposed regulations under section 367(a)(5) raise questions regarding the interaction of section 356(a)(2) with section 367(b) and other provisions. One commentator suggested two alternative views for consideration but only in the context of outbound reorganizations.[857] The first is that, in certain cases, there may be no sufficiently compelling reason of international tax policy to require that the rules of section 356 be displaced by the section 367(b) rules in the context of an outbound asset reorganization. Considerations supporting this view include the fact that the treatment of any boot received in an outbound reorganization (at least in situations where there is an outbound transfer of United States property within the meaning of section 956(c) to a CFC) would need to be coordinated with the rules of section 956. In particular, to the extent that the outbound transfer of United States property would result in subsequent subpart F inclusions under section 951(a)(1)(B),[858] the untaxed earnings and profits of the acquiring CFC would remain subject to U.S. taxation and, accordingly, there may be no compelling need to recharacterize the boot received pursuant to an outbound reorganization as a dividend. The same commentator noted also that, in other situations in which a U.S. parent disposes of its shares of a target corporation (excluding transfers to which section 304 applies), the U.S parent would be entitled to reduce the amount of gain realized on the sale by its basis. The commentator suggested that it is not clear why the presence of an outbound reorganization should displace this concept in favor of taxation of the non-previously taxed earnings of a foreign acquiring corporation. On the other hand, it could be argued that reorganization treatment is an exception to sale treatment, based in part on the concept of continuing ownership, thus justifying different treatment. If the closely held nature of the participants to these types of outbound transactions is a particular concern, the commentator suggested that concern could be addressed through more traditional means (e.g., a finding that the transaction lacked a business purpose).

The second alternative suggested by the same commentator is that, consistent with previously issued guidance under section 367(b) addressing cross-border reorganizations, section 367(b) should override section 356(a)(1) and require all boot received by a U.S. corporation in the context of an outbound asset reorganization to be subject to current U.S. federal income taxation without regard to the amount of gain realized by target shareholders. More specifically, all boot received in these types of reorganizations could be treated as a severable, pre-reorganization dividend from the foreign acquiring corporation.[859]

Another commentator suggested it would be inappropriate to issue guidance under section 367, because Congress has determined when gain shall be recognized and the amount of

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[857] New York State Bar Association Tax Section, "Report on Proposed Regulations Issued under Code Sections 367, 1248 and 6038B," 2009 *Tax Notes Today* 17-18 (January 28, 2009), Section IV.J.

[858] Many factors affect an inclusion under section 951(b)(1)(B) including the adjusted basis of U.S. property and the amount of earnings and profits at the CFC.

[859] See, e.g., Treas. Reg. sec. 1.301-1(l) and *Bazley v. Commissioner*, 331 U.S. 737 (1947).

such gain constituting a dividend under section 356. This commentator also urged that any previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule will be preserved for future taxation, and any value attributable to the assets transferred will be maintained, suggesting that there has not been a constructive distribution.[860]

Scope of the proposal

A general premise of the transaction discussed above is that there is a foreign acquiring/transferee corporation that is acquiring the property of a target/transferor corporation (presumably foreign) from its U.S. parent in return for cash or other boot. By acquiring the other corporation's assets from its U.S. parent, the foreign acquirer is able to repatriate cash with little or no U.S. taxation under the boot-within-gain limitation of section 356(a). The proposal, however, also would apply to any other transaction under section 356(a)(1) where the exchange has the effect of a distribution of a dividend, as determined under section 356(a)(2). Thus, the proposal may apply to domestic-to-domestic reorganizations with a foreign shareholder where there may be the potential for withholding tax avoidance. Additionally, the proposal may also apply to domestic-to-domestic reorganizations with a U.S. shareholder, where there may be no withholding tax avoidance intended but where the proposal would increase the amount treated as a dividend. In those circumstances in which the U.S. shareholder is only entitled to a dividends received deduction of less than 100 percent, the result may be an increase in U.S. taxation.[861]

Other technical considerations

Under the proposal, if the boot received by any exchanging shareholder in a reorganization transaction or section 355 distribution, whether domestic or foreign, has the effect of a distribution of a dividend, then the amount treated as a dividend would not be limited to gain on the transaction. However, it is not clear to what extent the dividend treatment would otherwise be consistent with the rules for identifying and measuring nonreorganization dividends.

While the proposal is clear in its intent to repeal the boot-within-gain limitation under the aforementioned circumstances, it does not specifically discuss the manner in which the boot will be taxed to the extent it is not subject to the boot-within-gain limitation. As discussed above, section 356(a)(2) requires treating the gain as a dividend to the extent of accumulated earnings and profits with any additional gain being treated as gain from the exchange of property. Since the intent of the proposal is only to repeal the applicability of the boot-within-gain limitation rule and not the treatment of the transaction as one to which sections 354, 355 and 356 apply, one could conclude that section 356(a)(2) would still apply but would treat the entire amount of boot

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[860] American Institute of Certified Public Accountants, "Comments on the Proposed Regulations on Transfers Subject to Section 367(a)(5) and Certain Cross-Border Asset Reorganizations and Nonrecognition Distributions of the Stock of Certain Foreign Corporations by Domestic Corporations," 2009 *Tax Notes Today* 100-19 (May 20, 2009), p. 11. But see the view expressed in Jasper L. Cummings, *op. cit.*, *supra*, that corporate earnings may be reduced by the full amount of boot in a reorganization.

[861] Sec. 243(a).

as a dividend to the extent of accumulated earnings and profits not limited by gain. To the extent the boot received exceeds the accumulated earnings and profits and there is any remaining gain realized, such gain would be recognized and treated as gain from the sale or exchange of property. To the extent there is any remaining boot over and above the gain, presumably it would be treated as a tax-free return of basis. Nonetheless, the intended treatment of this additional boot may require further clarification. In addition, consideration might be given to whether it would be desirable to more closely conform the treatment of dividends in reorganization transactions to the treatment of other dividends.

Another issue that may require clarification is the source of the accumulated earnings and profits from which the deemed dividend is generated under section 356(a)(2). As discussed above, conflicting positions exist under present law as to whether the accumulated earnings and profits taken into account should be that of both the transferor and acquiring corporation or, instead, be limited to only that of the transferor corporation. To the extent that the boot-within-gain limitation rule is repealed for such transactions, it will undoubtedly create more scenarios in which the boot amount will exceed the accumulated earnings and profits of either the transferor or acquiring corporation on a stand-alone basis. Therefore, additional guidance may be necessary to determine the source of any deemed dividend under section 356(a)(2). While one of the two approaches discussed above could be pursued, an alternative would be to adopt a rule similar to that which applies to boot received in an intercompany reorganizations within a consolidated group that would otherwise be covered under section 356(a)(2).[862] Such a rule would require that the boot be taken into account after completion of the reorganization which would be based on the combined earnings and profits of the acquiring corporation and target corporation.[863]

In addition, as discussed above, there is a potential lack of clarity under present law whether a reference to "earnings and profits accumulated" includes current earnings and profits for the year of the distribution, and whether a limitation on the reduction of earnings and profits under section 312(n)(7) applies in the case of a reorganization distribution that is not treated as a dividend to the shareholder. Additional guidance may be desirable regarding these issues.

Finally, it can be argued that, while the repeal of the boot-within-gain limitation when there is a foreign acquiring corporation will limit the ability of taxpayers to repatriate earnings with little or no tax, it may have other unintended consequences that may be used affirmatively by taxpayers for planning purposes. By way of example, section 304 was enacted to prevent

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[862] Treas. Reg. sec. 1.1502-13(f).

[863] The proposal does not limit the situations to which it applies only to those of entirely common ownership. Compare Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, pp. 267-68 (2001), recommending a similar proposal but only for certain types of reorganizations. However, the proposal is arguably further simplifying in applying the same rules to all cases in which an exchange has the effect of a dividend. Looking to the earnings and profits of both companies would arguably be consistent with the approach of *Clark v. Commissioner, supra,* which measured the deemed redemption for dividend equivalence on the basis of the stock that would have been owned by a shareholder in the combined corporations after the reorganization.

what were deemed to be abusive transactions by taxpayers to convert what would otherwise be dividends into capital gain transactions. Today, taxpayers typically only trigger section 304 when they are affirmatively using it for foreign tax credit and cash repatriation planning purposes. Depending on the manner in which the repeal of the boot-within-gain limitation rule is implemented, it may be expected that similar tax planning opportunities will arise (e.g., if the earnings and profits sourcing and ordering rules differ from those under section 304).

Prior Action

The President's fiscal year 2010 budget proposal contained a similar proposal, but limited that proposal to asset reorganizations involving a foreign acquiring corporation.

7. Treat income of partners for performing services as ordinary income

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxable upon the receipt of the partnership interest.[864]

In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profit interest for services as not a taxable event for the partnership or the partner.[865] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[866] clarifies that this treatment applies provided the service partner takes

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[864] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. 530 (1971), aff'd 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner,* 943 F. 2d 815 (8th Cir. 1991)).

[865] Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

[866] Rev. Proc. 2001-43 (2001-2 C.B. 191). This result applies under the guidance even if the interest is substantially nonvested on the date of grant.

into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[867]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[868] A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[869]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[870] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

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[867] A similar result would occur under the "safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

[868] Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1); see *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).

[869] Rev. Proc. 93-27, 1993-2 C.B. 343.

[870] Sec. 83(h).

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[871] The proposed regulations provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also contain a rule that permits a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant) in a partnership, under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[872] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower income tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a

[871] 70 Fed. Reg. 29675 (May 24, 2005).

[872] Sec. 702.

passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Employment tax treatment of partners

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").[873] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[874]

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.[875] The amount of wages subject to this component is capped at $106,800 for 2011. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[876]

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 $106,800 for 2011. 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.

For SECA tax purposes, net earnings from self-employment means 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.[877] Specified types of income or loss are excluded, such as rentals from real estate in

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[873] See Chapter 21 of the Code.

[874] Sec. 1401.

[875] Secs. 3101 and 3111.

[876] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

[877] 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).

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.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[878] In determining a limited partner's net earnings from self-employment, an exclusion is 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.

For taxable years beginning after 2012, in the case of an individual, estate, or trust, an unearned income Medicare contribution tax is imposed.[879] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[880] 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 any other case.

Description of Proposal

The proposal generally treats net income from an interest in an investment partnership as ordinary income if the partner provides personal services, except to the extent income is attributable to the partner's invested capital. Thus, the proposal recharacterizes the service partner's distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands of the partner. Such income is taxed at ordinary income tax rates and is subject to self-employment tax under the proposal.

The proposal also recharacterizes as ordinary the gain from sale or exchange of such a partnership interest, except to the extent gain is attributable to the partner's invested capital.

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

[879] Sec. 1411.

[880] Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1), net of the deductions and exclusions disallowed with respect to foreign earned income.

The proposal defines invested capital as money or other property that the partner contributes to the partnership, not including the proceeds of any loan or advance made by any other partner or by the partnership.

An investment partnership is a partnership, the majority of whose assets are investment-type assets, but only if more than half of the partnership's contributed capital comes from partners in whose hands the partnership interests are property held for the production of income, rather than trade or business property. For this purpose, investment-type assets are certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets.

To prevent circumvention of the general rule through use of separate entities, the proposal provides that a person who performs services for an entity and holds a disqualified interest in the entity is subject to ordinary income treatment for income and gain with respect to the entity. A disqualified interest includes convertible or contingent debt, an option, or a derivative instrument with respect to the entity. The proposal is not intended to affect the qualification of a real estate investment trust holding a carried interest in a real estate partnership.

Effective date.−The proposal generally is effective for taxable years beginning after December 31, 2011.

Analysis

In general

The central issue raised by the proposal is whether it is conceptually correct to treat partnership income of service providers in investment partnerships as ordinary income in the nature of compensation for services. Arguments can be made about whether partnership income should lose its underlying character and be treated as ordinary income (and be subject to employment tax) because the recipient partner contributes labor to the partnership. Administrability of the proposal is a corollary issue. A related but larger issue is that these income tax concerns would be eliminated by equalization of the tax rates on labor and capital income.

An interest of a service provider in a business is sometimes referred to as a carried interest, particularly as used in specialized businesses such as oil and gas exploration and investment fund management. A carried interest generally is a right to receive a percentage of profits without an obligation to contribute capital to the activity. In the case of a partnership, the carried interest may be structured as a partnership profits interest, under which the partner has a right to receive a percentage of partnership profits, but has no obligation to contribute capital to the partnership, and has no right to partnership assets on liquidation of the partnership.[881] A

[881] As income is earned by the partnership but is not yet distributed to the partner with the profits interest, the partner's share of these earnings is credited to his capital account. However, the capital account is reduced when the earnings are distributed to the partner. Thus, the partner does not have rights in liquidation of the partnership once his profit share is distributed to him. Alternatively, in the investment fund management business, for example, the assets invested in the fund generally are managed by a group of individuals who contribute a relatively small

partner with only a profits interest generally does not have an obligation to contribute to the partnership's capital if the partnership experiences losses.

Fundamental tax policy issues relating to carried interests

In general

Historically, labor income of individuals has generally been taxed at ordinary rates, while some forms of capital income[882] have generally been taxed at lower rates.[883] In addition, labor income generally is subject to employment tax (generally 2.9 percent for amounts over $106,800, in 2011). In 2011, for individuals generally, the top rate of tax on capital gain is 15 percent, while the top rate on ordinary income is 35 percent. When the employment tax is added, the top rate on ordinary compensation income in excess of $106,800 is 37.9 percent for 2011. This rate differential is thought to be a motivating factor in taxpayers' choice to structure income as a carried interest that can give rise to capital gain rather than as fees or other ordinary compensation income. Carried interests may also be structured to achieve deferral of income compared to alternative structures.

Capital income or compensation

Analysis of the proposal raises the question whether the carried interest is a form of compensation for services, or whether it is more similar to a right to income or gain from capital.

In many cases, it is fairly clear whether money is paid for services rendered, on the one hand, or for the use of capital as equity or debt, on the other hand. This distinction can become more difficult, however, in a business activity involving capital assets and individuals' services with respect to the capital assets. Issues relating to the distinction between gains and earnings from investment in property, on the one hand, and income from the performance of services or from other types of businesses, on the other hand, can be found in many areas. The distinction

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amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

[882] In general, capital income taxed at lower rates has historically included capital gain. Qualifying dividend income of individuals has been taxed at the same maximum rate as capital gain since 2003. This treatment is scheduled to expire at the end of 2012, as are the current maximum rates for both ordinary income and capital gain. However, during the 1970's, income from services was taxed at a maximum rate of 50 percent while investment income, including dividends, but not including capital gain, was taxed at a higher maximum rate of 70 percent. As an exception to the generalization that capital gains have historically been taxed at a rate lower than labor income, for taxable years beginning in 1988, 1989, and 1990, the maximum tax rates of individuals on all income, ordinary as well as capital gain, was 28 percent.

[883] When labor income and capital income are taxed at the same rates, then issues of the character of income (i.e., whether capital or ordinary) are much less significant. Some distinctions between capital and ordinary income would remain, however, even if the tax rate differential were eliminated. Unlike ordinary income treatment, capital gain treatment entitles investors to tax-free return of basis to the extent of basis in the asset. Another difference between ordinary and capital gain treatment is that capital losses are subject to a limitation on deductibility against ordinary income. Issues of timing (i.e., when income is taxed) are not affected by setting capital and ordinary income rates at the same level.

has been a general source of complexity.[884] Distinctions have been established legislatively for tax purposes in some instances, for example, a self-created copyright, which is treated as property that is not a capital asset.[885]

If the service provider does not contribute capital, but only his labor, the carried interest arrangement involves the performance of services by the individual whose work gives rise to capital income for owners who have contributed capital. While the individual's economic interests are aligned with those of capital investors in the business to the extent that his compensation is based on the positive investment yield of the business, the individual is nevertheless performing services, not receiving a return on contributed capital. Therefore, it is argued that the income should be taxed as ordinary compensation income.

A variety of arguments that such income should not be treated as ordinary compensation have been advanced, principally in the context of the investment management business.[886] For example, it is argued that the service provider with a carried interest is taking economic risk by working in the business and should therefore not be treated as having ordinary compensation income if the income that would flow through the partnership is eligible for capital gains rates. The notion is that capital gains rates are accorded when risk is taken. The risk argument can be criticized, however, in that the capital gains rates apply to the disposition of capital assets, not to risk-taking in general that does not involve capital assets. Moreover, the capital gains tax rates do not apply to many types of income related to risk-taking. For example, capital gains rates do not apply to employee compensation that is performance-based, contingent on meeting sales targets or other performance measures. To the extent that the service provider is risking his time and effort, but not his money, it is argued that the risk rationale for capital gains treatment does not apply.

Another argument made in opposition to the idea of treating income from a carried interest as ordinary income is that the carried interest gives rise to equity, or capital, termed "sweat equity" or "founder's equity." Present law generally treats gain or loss on sale or exchange of an interest in a business in which the seller worked as from the sale or exchange of a capital asset. This is conceptually correct in that a capital asset has been created, it is argued,

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[884] See, e.g., *Commissioner v. Jose Ferrer,* 304 F.2d 125 (2d Cir. 1962), rev'g 35 T.C. 617 (1961), involving a disputed distinction between compensation for acting services, on the one hand, and capital gain from the disposition of property rights in the resulting productions, on the other. See also Boris I. Bittker and Lawrence Lokken, *Federal Income Taxation of Income, Estates, and Gifts,* Third Edition, 1999, 3-73.

[885] See, e.g., section 1221(a)(3)(A), providing that certain copyrights and other property in the hands of a taxpayer whose personal efforts created the property are not a capital asset and thus are not eligible for capital gain treatment; section 751 (gain on sale of a partnership interest is not capital gain to extent it reflects certain unrealized receivables, including certain rights to payment for services); section 7701(e)(1) (providing for recharacterization of a services contract as a lease in certain situations).

[886] A discussion of this issue in the context of fund managers and fund investors, with references to related articles, appears in Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. See also the related document, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. These documents are available on the internet at www.jct.gov.

and by analogy to present-law treatment, income from a carried interest should not be recharacterized. Nevertheless, present law does not treat operating income from a business (for example, from a barber shop, or a widget manufacturing operation) as capital gain to the extent labor contributed to the business creates capital; and the proposal applies to the service provider's share of operating income of a partnership (as well as to gain on disposition of the partnership interest). Furthermore, while the proposal would tax as ordinary income the service provider's share of operating income of the business, the proposal also provides that amounts attributable to invested capital are not recharacterized as ordinary income. Thus, the proposal retains the notion that the service provider's share of capital income from the business, if any, is eligible for capital gains rates.

Separating labor income and capital income

If the service provider contributes capital to the partnership in addition to his labor, it could be argued that separating the capital income from the labor income would be difficult and fact-dependent. This difficulty could make the proposal to tax labor income as ordinary hard to apply and inaccurate in measuring labor income in many cases, perhaps in so many cases as to render the proposal ineffective at taxing labor income as ordinary without changing the treatment of capital income. On the other hand, if other partners have capital interests similar to the service provider's capital interest, it may not be so difficult to identify the return on the service provider's capital interest in the partnership by reference to the other partners' similar capital interests.

The issue of separating labor income from capital income becomes more complex if capital assets of the business are created by the owner's labor in the business. The business owner working in the business may have an increasingly large interest in capital assets of the business as his labor makes the business grow (the owner's "sweat equity"). It could become quite difficult to identify the portion of operating income of the business that is properly allocable to the individual's labor, and the portion allocable to his interest in business capital.[887]

[887] In the context of investment management businesses, this issue has been raised by commentators. See New York State Bar Association Tax Section, *Report on Proposed Carried Interest and Fee Deferral Legislation* (September 24, 2008), pp. 19-52, criticizing the operation of the invested capital rule of section 201 of H.R. 6275; Michael L. Schler, "Taxing Partnership Profits Interests as Compensation Income," *Tax Notes* (May 26, 2008), pp. 829, 846-851, analyzing the invested capital rule of section 611 of H.R. 3996. For other recent commentary, see Carol Kulish Harvey, James B. Sowell, and Deborah Fields, "I Spy an ISPI--Expansive Breadth of Carried Interest Proposals," *Tax Notes* (August 2, 2010); Karen C. Burke, "Back to the Future: Revisiting the ALI's Carried Interest Proposals," *San Diego Legal Studies Paper 09-026* (August 2009); Karen C. Burke, "The Sound and Fury of Carried Interest Reform," *San Diego Legal Studies Paper 09-023* (July 2009); Karen C. Burke, "Fuzzy Math and Carried Interests: Making Two and Twenty Equal 710," *San Diego Legal Studies Paper 09-008* (April 2009); Monte A. Jackel and Robert J. Crnkovich, "Partnership Deferred Compensation and Carried Interests," *Tax Notes* (April 20, 2009), p. 351; Paul Carman, "Taxation of Carried Interests," *Taxes-The Tax Magazine* (March 2009), p. 111; Mark P. Gergen, "A Pragmatic Case for Taxing an Equity Fund Manager's Profits Share As Compensation," *Taxes-The Tax Magazine* (March 2009), p. 139; Joel Scharfstein, "Proposed Carried Interest Legislation: The Interaction of Invested Capital and Book-ups," *Taxes-The Tax Magazine* (March 2009), p. 151; Gregg. D. Polsky, "Private Equity Management Fee Conversions," *Tax Notes* (February 9, 2009), p. 743; Philip F. Postlewaite, "15 and 35: Class Warfare in Subchapter K," *Tax Notes* (January 26, 2009), p. 503; Howard Abrams, "Carried Interests: The Past Is Prologue," *Emory University Law & Economics Research Paper No. 08-32* (September 2008); Raymond J.

To simplify the analysis, assume the individual performs about the same amount of services in the business every year, and the business grows annually and generates an increasingly large amount of operating income allocable to the service provider's ownership interest. Should the amount of this operating income that is treated as labor income remain constant because the individual's services remain constant, or should the amount of labor income grow somewhat as he becomes more experienced and better at the job? Or should the amount of operating income treated as capital income grow in accordance with the growth of the business or the value of the individual's share of the capital assets, even if this results in a reduction or elimination of the amount treated as the individual's labor income (while he is still working at a fairly constant rate)?

Litigation over the issue of reasonable compensation demonstrates that ascertaining the value of personal services is fact-driven and often requires case-by-case analysis, particularly for services of an entrepreneur for which comparables may not be so readily available as for other types of labor.

As an alternative to measuring the labor income, deriving the measure of capital income by comparing other similar capital interests in the partnership may also be difficult in many cases. For example, it is possible that a partnership will not "book up" its assets (i.e., increase the value shown on the partnership's books and records) to reflect the increase in value of the business, for example, if no new partners have been admitted. Thus, it may be difficult to ascertain the relative values of the partnership interests of the service provider and the non-service providing partners. It may be that partners have little or no capital on the books of the partnership, for example, in the situation in which a closely held partnership has borrowed to make distributions, perhaps in an amount exceeding contributed capital. As a result, in these and other fact situations, it is possible that the service partner's interest in partnership capital cannot be readily measured by comparison to other partners' capital interests or even by the more limited yardstick of contributed capital.

On the other hand, it can be said that whether a partnership conducts a business or is engaged in an investment activity, in either case it is for profit, and the partners know what their capital interests are. While there may be cases on the fringe in which measurement is difficult due to peculiar facts, the great majority of situations permit quantification of the capital of partners who have contributed capital. In measuring partners' capital, one option, which is

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Elson and Leonard G. Weld, "Taxation of Private Equity Firms: Good Tax Policy or Just Income Redistribution by Congress?," *Taxes-The Tax Magazine* (September 2008), p. 35; Douglas A. Kahn, "The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest," 62 *Tax Lawyer* (Fall 2008), p. 1; Chris William Sanchirico, "The Tax Advantage of Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?," 75 *Chicago Law Review* (2008), p. 1071; David A. Weisbach, "The Taxation of Carried Interests in Private Equity," 94 *Virginia Law Review* (2008), p. 715; Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," 50 *William & Mary Law Review* (2008), p. 115; Carol Kulish Harvey and Eric Lee, "A Technical Walk Through the Carried Interest Provisions Contained in Chairman Rangel's Tax Reform Proposal," *Taxes-The Tax Magazine*, (February 2008), p. 77; Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," 83 *NYU Law Review* (2008), p. 1; James H. Lokey, Jr. and Donald E. Rocap, "Selected Tax Issues in Structuring Private Equity Funds," 62 *N.Y.U. Institute* (2004), p. 509.

adopted by the proposal, may be to provide rules to measure service partners' capital by reference to other partners' capital. This approach treats as ordinary income the distributive share of an individual who holds an investment services partnership interest, and would exclude from ordinary income treatment the income and gain attributable to the partner's qualified capital interest. A qualified capital interest is measured by the amount of contributed capital, amounts included in income on receipt of the partnership interest by virtue of section 83, and the partner's share of partnership income and gain that has not been distributed to him. This approach looks to other similar capital interests of partners that do not provide services to determine whether earnings of the service provider are from a qualified capital interest and therefore not subject to ordinary tax rates. Such qualified capital interest rules would tend to function more smoothly for some business activities, such as investment partnerships with significant capital contributed by investors, than perhaps they would in less capital-intensive businesses.

Dispositions

A related question involves whether it is appropriate for the proposal to provide a distinction between income from labor and income from capital upon sale or exchange of the individual's interest in the business at a gain. Present law generally allows capital gain treatment for this type of "sweat equity" on sale or exchange of an interest in a business; such an interest is generally treated as a capital asset.[888]

The proposal provides that gain on sale of the service provider's interest in an investment management partnership is treated as ordinary income. Arguably, ordinary treatment on disposition of the partnership interest is a necessary corollary of the basic rule of the proposal that the partner's share of gain from partnership operations is ordinary. If current income and gain were recharacterized as ordinary, but gain on disposition were not recharacterized as ordinary, an incentive would be created to defer realization until the partner disposes of his interest, rather than having the partnership dispose of its assets at will. The rule recharacterizing current income and gain as ordinary would be largely vitiated in the absence of a parallel rule for disposition gain.

On the other hand, an analogy to present-law capital gain treatment, generally, on the sale of a partnership interest could suggest that some portion, at least, of gain on disposition of an interest in an investment management partnership interest should be capital gain, to reflect the service provider's "sweat equity." In the absence of an easy method of quantifying "sweat equity," proponents of this argument might suggest that a set percentage of gain on disposition should escape recharacterization as ordinary.

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[888] The same sets of questions arise if the business is not successful and generates operating losses and a loss upon sale or exchange of the service performer's interest in the business. Present law generally treats operating income and operating losses of a business as ordinary, so the question as it relates to net operating income primarily involves the employment tax impact of the proposal. If the business is a partnership, generally partners are subject to self-employment tax on net income of the business, which takes into account operating losses in determining the amount of net earnings from self-employment.

Nevertheless, present law provides for ordinary treatment on disposition of a partnership interest to the extent the partner is considered to dispose of a share of ordinary-income-producing assets such as unrealized receivables and inventory items. The acknowledgement of the existence of an ordinary portion of gain on disposition of a partnership interest under present law may lend support to the idea that a service partner's interest yields ordinary income except to the extent of his qualified capital interest.

Employment (or self-employment) tax and additional HI tax

A corollary issue relates to the employment tax treatment of income received under a carried interest. Because dividends and capital gain are not subject to employment taxes under present law,[889] the desire to avoid employment or self-employment tax, and at higher income levels to avoid the application of the 2.9 percent hospital insurance portion of the tax (which is not subject to an income cap), may motivate taxpayers to structure payments through carried interests. However, to the extent income from carried interests is viewed as labor income, failing to subject these amounts to employment or self-employment tax, while other compensation is subject to such taxes, can lead to economic inefficiency and to distortion.[890]

In the case of taxpayers subject (after 2012) to the 3.8 percent unearned income Medicare tax, consideration would have to be given to the treatment under that provision of income that is recharacterized as ordinary under this proposal. If income is treated as ordinary because it is services income, then arguably, the exception from the 3.8 percent tax for certain active businesses should apply. On the other hand, if that exception is intended to benefit small business, an argument could be made that no exception should apply in the case of carried income that exceeds some high level.

Issues relating to complexity, administrability, and scope of the proposal

Additional complexity

Characterizing income from carried interests as ordinary compensation income arguably introduces significant additional complexity to the already complex tax law relating to partnerships. The additional complexity arises from the potential need to identify and separate labor income from capital income, to identify comparable capital interests among partners (especially in cases in which the partnership does not have distinct classes of capital interests), and to ascertain and "book up" the value of the partnership in more situations than under present law, for example. The proposal may cause sophisticated taxpayers to engage in tax-motivated restructuring of current and future business arrangements seeking to avoid the tax cost of

[889] However, for taxable years beginning after 2012, in the case of an individual, estate, or trust, an unearned income Medicare contribution tax is imposed a rate of 3.8 percent on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount.

[890] The inefficiency arises because the taxpayer is motivated to choose the form of business with the highest after-tax return, potentially foregoing the activity or structure with the highest pre-tax return, which would maximize the societal benefit (economic efficiency). In addition, the cost of tax planning to achieve the highest after-tax return can be viewed as distortive, diverting resources away from other productive business activities.

ordinary income treatment to the partner providing services. The additional complexity and the tax-motivated behavioral responses to such a change in the tax rules arguably create inefficiencies and distortions in the economy that reduce overall productivity.

Less sophisticated taxpayers engaged in business in partnership form may unknowingly violate the proposal due to its potential complexity and difficulty of application. For example, in the case of a small business in partnership form whose capital structure does not lend itself to comparison of similar capital interests, the proposal may not function effectively to exclude from ordinary income treatment the income from the service provider's capital interest in the partnership; this analysis could be complex.

While the proposal could be criticized as a trap for the unwary in the case of unsophisticated taxpayers, partnerships engaged in the investment management business (to which the proposal is limited) generally are composed of highly financially sophisticated people for whom this concern is not of practical significance. The preference for simplicity in the tax law should be balanced with fairness and accuracy of income measurement. The perception that taxpayers with income from different categories of personal services are taxed at disparate rates may increase noncompliance among taxpayers who believe that they are over-taxed or who believe that the tax system is inherently unfair. Given the limited scope of the proposal, the detriment of additional complexity is outweighed by the benefit of an improvement in the perceived fairness of the tax law and improved accuracy of income management.

Administrability

The proposal could be criticized as likely to encourage some sophisticated taxpayers to engage in tax planning behavior that gives rise to economic distortions and consumes resources that could be devoted to other productive business activity. On the enforcement side, the proposal may require disproportionate audit resources due to the complex and fact-specific analysis that could be needed to determine compliance. On the other hand, it is possible that administrative guidance or procedures could be developed to clarify the application of the provision in common fact situations involving the investment management industry, improving the efficiency of the administration of the provision both for the government and for taxpayers.

Scope of the proposal

The use of carried interests is not limited to a particular type of business activity, but may extend to any business in which investors desire to align the interests of managers or other service providers who contribute labor to the partnership's business with the interests of investors. This is achieved by using positive investment yield as the measure of service providers' income. Under the tax rate structure of present law, with lower rates for capital gains and dividends than for ordinary income, this arrangement may be attractive in businesses whose profits include capital gains and dividends.

The principle of horizontal equity in the tax law (that similarly situated taxpayers should be subject to similar tax burdens) suggests that labor income of all individual taxpayers should be taxed at comparable rates, whether it is earned through a partnership or directly. Thus, the principle of horizontal equity might suggest that the proposal should apply to all types of

partnerships.[891] However, the proposal relates to carried interests in investment partnerships, rather than partnerships engaged in all businesses.

Applying the recharacterization rule of the proposal only to carried interests in investment management businesses arguably captures a significant portion of labor income that is currently taxed at capital gains rates, without imposing needless tax complexity on other types of businesses. Very few partners outside the asset management business − due to the nature of their business assets and activities − can convert material amounts of labor income to capital gains and dividends, thus lowering the tax rate and avoiding employment and self-employment tax that applies to individuals who earn labor income directly. Most business activities are not so inherently conducive to such conversion and avoidance. Thus, it is argued, it makes sense to limit the scope of the proposal to businesses involving significant capital such as investment management services, rather than to extend ordinary income and employment tax treatment to service-providing partners in any business. Operating income of most businesses is already ordinary income under present law.

It may be noted that these income tax issues, including the most basic issue of whether the service partner's income is from labor or capital, would disappear or be mooted if labor income and capital income were taxed under the same rate schedule. If the tax rate schedule were the same for all types of income of individuals, horizontal equity would be satisfied and there would be no income tax impetus for the proposal. However, the policy implications of such a rate shift, and the corollary changes that might be necessitated, raise many broader issues than the proper income tax treatment of service-providing partners. Further, the employment (or self-employment) tax issue would not be addressed by equalizing income tax rates.

Prior Action

A similar proposal applicable to all partnerships was included in the President's fiscal year 2010 and 2011 budget proposals.

8. Deny deduction for punitive damages

Present Law

A deduction is allowed for all ordinary and necessary expenses paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[892] The Internal Revenue Service has ruled that amounts paid as punitive damages incurred by the taxpayer in the ordinary conduct of its business operations are deductible as an ordinary and necessary business expense

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[891] Previous Administration budget proposals for fiscal 2010 and 2011 included a similar proposal that applied to service providers in all partnerships, not just investment management partnerships. See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part One: Individual Income Tax and Estate and Gift Tax Provisions* (JCS-2-09), September 2009, 110-122, *and Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal* (JCS-2-10), August 16, 2010, pp. 385-397.

[892] Sec. 162.

under section 162.[893] A deduction is not allowed, however, for any payment made to an official of any government or governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[894] In addition, under section 162(f), no deduction is allowed for any fine or similar payment made to a government for violation of any law.[895] The enactment of section 162(f) in 1969 was intended to codify existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that allowance of the deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct."[896] Further, no deduction is allowed for two-thirds of the damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.

In general, gross income does not include amounts received on account of personal injuries or sickness.[897] This exclusion generally does not apply to punitive damages.[898]

Description of Proposal

The proposal repeals the deduction for punitive damages paid or incurred as a judgment or in settlement of a claim. If a liability for punitive damages is covered by insurance, any such damages paid by the insurer would be included in gross income of the insured person, and the insurer would be required to report such amounts to both the insured person and the IRS.

Effective date.–The proposal is effective for punitive damages paid or incurred after December 31, 2012.

Analysis

Proponents of the proposal argue that allowance of a tax deduction for punitive damages undermines the role of punitive damages in deterring and penalizing the activities or actions for

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[893] Rev. Rul. 80-211, 1980-2 C.B. 57.

[894] Sec. 162(c).

[895] Sec. 162(f).

[896] S. Rep. No. 91-552, 9st Cong., 1st Sess. 273-74 (1969), referring to *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1956). In a series of cases, the Supreme Court had disallowed a deduction if allowing the deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct." *Commissioner v. Heininger*, 320 U.S. 467, 473 (1943). The Supreme Court further clarified that the "policies frustrated must be national or state policies evidenced by some governmental declaration of them" (*Lilly v. Commissioner*, 343 U.S. 90, 97 (1952)) and the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction" (*Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1956)).

[897] Sec. 104(a).

[898] Pub. L. No. 104-188; *K.M. O'Gilvie v. U.S.*, 519 U.S. 79 (1996).

which the punitive damages were imposed.[899] Thus, proponents argue that, as a matter of public policy, punitive damages should not be deductible, because punitive damages deducted as an ordinary and necessary business expense reduce a taxpayer's taxable income, and correspondingly its Federal income tax liability.[900] This deduction essentially transfers a portion of the cost of the punitive damages to the Federal government, thereby undermining the effectiveness of the punitive damages as a deterrent.[901]

Those advocating denial of a deduction for punitive damages also note that the provision is easily administrable: the determination of the amount of punitive damages generally can be made by reference to pleadings filed with a court, and such determination is already made by plaintiffs in determining the portion of any payment that is taxable.

Opponents of the proposal argue that a deduction should be allowed for all ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business in order to properly measure the income of the taxpayer. They argue that disallowance of punitive damages would result in the taxpayer paying taxes on amounts in excess of his income, essentially imposing an additional direct Federal fine.[902] Opponents also note that determining the amount of any punitive damages will be difficult in many cases, especially where the payment arises from the settlement of a claim.[903] A similar issue arises in cases where compensatory damages are too difficult or too costly to accurately calculate, with the result that the punitive damages may have a compensatory element.[904]

Others question whether punitive damages serve as a deterrent and, therefore, whether the disallowance of a deduction would approximate the optimal penalties to deter certain behaviors in the most efficient manner.[905] Moreover, some question whether reliance on the Federal tax system to influence societal objectives is more efficient than non-tax legislative or regulatory

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[899] Kimberly A. Pace, "The Tax Deductibility of Punitive Damages: Who Should Ultimately Bear the Burden of Corporate Misconduct?" 47 *Alabama Law Review* 826, pp. 863-861 (1968).

[900] *Ibid*. See also, Catherine M. Del Castillo, "Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine," 68 *Texas Law Review* 819, p. 838 (1990).

[901] See, e.g., *New York State Bar Association Tax Section*, "The Deductibility of Punitive Damages," 2001 TNT 213-21 (Nov. 26, 2001), noting that "A principal point of punitive damages is to 'send a message' for past bad conduct, making them more akin to criminal punishment. They are an 'unusual remedy to punish unusually serious misconduct' and are awarded only against defendants who have been 'really mean' or 'really stupid.'" [Citations omitted.]

[902] Eric M. Zolt, "Deterrence Via Taxation: A Critical analysis of Tax Penalty Provisions," 37 *UCLA Law Review*, pp. 343, 351 (1989).

[903] W. Kip Viscusi, "The Challenge of Punitive Damages Mathematics," 30 *Journal of Legal Studies* pp. 313, 342-43 (2001).

[904] Robert W. Wood, "Why Punitive Damages Should Remain Deductible," 124 *Tax Notes* 149 (July 13, 2009).

[905] Zolt, *supra* pp. 360-374.

actions or market forces.[906] Still others suggest that rather than change Federal tax policy with respect to punitive damages, revising jury instructions to educate juries as to the after-tax cost of punitive damage awards would be a more appropriate approach.[907]

Some might argue that the judicial public policy doctrine obviates the need for a statutory provision limiting deductibility of punitive damages. They would contend that the judicial doctrine is more flexible than a statutory provision, and targets the most egregious cases. Others might counter that, based on the lack of cases limiting a deduction for punitive damages, the judicial doctrine is not serving as an effective deterrent to the behaviors for which the damages are assessed. They might argue that a statutory denial of a deduction for punitive damages provides certainty and enhances compliance with the policies intended to be promoted by the imposition of punitive damages.

Prior Action

Substantially identical proposals were included in the President's budget proposals for fiscal years 2000, 2001, 2010, and 2011.

9. Repeal the lower-of-cost-or-market inventory accounting method

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in, first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in, last-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under the cost method or the "lower-of-cost-or-market" ("LCM") method.[908] Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, "subnormal goods", defined as goods that are unsalable at normal prices or in the normal way because of damage,

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[906] *The New York State Bar Association Tax Section*, "The Deductibility of Punitive Damages," 2001 Tax Notes Today 213-21 (November 26, 2001).

[907] Gregg D. Polsky and Dan Markel, "Taxing Punitive Damages," 96 *Virginia Law Review* 1295 (2010).

[908] Treas. Reg. sec. 1.471-2(c).

imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to net selling price, under either the cost or LCM method.

Description of Proposal

The proposal repeals the LCM method and the write down for subnormal goods. Appropriate wash-sale rules would be provided to prevent taxpayers from circumventing the prohibition. The proposal is treated as a change in method of accounting with any resulting section 481(a) adjustment taken into income ratably over four taxable years beginning with the year of change.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2012.

Analysis

Under present law, income or loss generally is not recognized until it is realized.[909] In the case of a taxpayer that sells goods, income or loss generally is realized and recognized when the goods are sold or exchanged. The LCM method and the write down for subnormal goods under present law represent exceptions to the realization principle by allowing the recognition of losses without a sale or exchange. In addition, these methods are one-sided in that they allow the recognition of losses, but not gains, even if the items of inventory recover their value in a subsequent year.

Nonetheless, the LCM method and the write down for subnormal goods have long been accepted as in accordance with generally accepted accounting principles ("GAAP") used in the preparation of financial statements and have been allowed by Treasury regulations for tax purposes since 1918. However, the mechanics of the tax rules differ from the financial accounting rules. Moreover, the conservatism principle of GAAP generally requires the use of the LCM method and the write down of subnormal goods so the inventory reflected on a company's balance sheet is not overstated relative to realizable values. There is no similar principle under Federal income tax law.[910]

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[909] The most notable exception to this is the mark-to-market rule of section 475, which requires dealers in securities to recognize gain or loss on the securities (other than securities held for investment) "as if such security were sold for its fair market value on the last business day of [the] taxable year."

[910] See, e.g., *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), wherein the Supreme Court noted, "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested…The primary goal of the income tax system, in contrast, is the equitable collection of revenue…Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.' In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable." [Citations omitted.]

Prior Action

A similar proposal for the repeal of the LCM method and subnormal goods write down was included in the President's budget proposals for fiscal years 1997, 1998, 1999, 2000, 2001, 2010, and 2011.

PART VI − ELIMINATE FOSSIL FUEL TAX PREFERENCES

A. Eliminate Oil and Gas Company Preferences

Present Law

In general

The Code includes a number of tax provisions that provide favorable treatment to investments in fossil fuel production projects.

Oil and natural gas production

Incentives for the production of oil and natural gas include the enhanced oil recovery credit, the marginal wells credit, the expensing of intangible drilling costs, the deduction for using tertiary injectants, the passive loss exemption for working interests in oil and gas properties, percentage depletion, the domestic manufacturing deduction for oil and gas production, and accelerated amortization for geological and geophysical expenses.

Some of these incentives are available to all domestic producers and all domestic production, while others target smaller producers or production that utilizes specific types of extractive technologies. Some of the incentives are not available (or are only partially available) to oil and gas producers whose production activities are integrated with refining and retail sales activities.[911]

Coal and other hard mineral fossil fuel production

Incentives for the production of coal and other hard mineral fossil fuels include expensing of exploration and development costs, percentage depletion, capital gains treatment for certain royalties, and the domestic manufacturing deduction.

Credit for enhanced oil recovery costs (sec. 43)

Taxpayers may claim a credit equal to 15 percent of qualified enhanced oil recovery ("EOR") costs.[912] Qualified EOR costs consist of the following designated expenses associated with an EOR project: (1) amounts paid for depreciable tangible property; (2) intangible drilling and development expenses; (3) tertiary injectant expenses; and (4) construction costs for certain Alaskan natural gas treatment facilities. An EOR project is generally a project that involves increasing the amount of recoverable domestic crude oil through the use of one or more tertiary

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[911] Integrated oil companies subject to these limitations are oil and gas producers that sell more than $5 million of retail product per year or refine more than 75,000 barrels of oil per year. Major integrated oil companies are a subset of integrated oil companies that (1) have average daily worldwide production exceeding 500,000 barrels per year, (2) had gross receipts in excess of $1 billion in 2005, and (3) own at least a 15 percent interest in a refinery that produces more than 75,000 barrels of oil per year.

[912] Sec. 43.

recovery methods (as defined in section 193(b)(3)), such as injecting steam or carbon dioxide into a well to effect oil displacement.

The EOR credit is ratably reduced over a $6 phase-out range when the reference price for domestic crude oil exceeds $28 per barrel (adjusted for inflation after 1991; $42.57 for 2010). The reference price is determined based on the annual average price of domestic crude oil for the calendar year preceding the calendar year in which the taxable year begins.[913] The EOR credit is currently phased-out.

Taxpayers claiming the EOR credit must reduce by the amount of the credit any otherwise allowable deductions associated with EOR costs. In addition, to the extent a property's basis would otherwise be increased by any EOR costs, such basis is reduced by the amount of the EOR credit.

Marginal well tax credit (sec. 45I)

The Code provides a $3-per-barrel credit (adjusted for inflation) for the production of crude oil and a $0.50-per-1,000-cubic-feet credit (also adjusted for inflation) for the production of qualified natural gas. In both cases, the credit is available only for domestic production from a "qualified marginal well."

A qualified marginal well is defined as a domestic well: (1) production from which is treated as marginal production for purposes of the Code percentage depletion rules; or (2) that during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95 percent of total well effluent. The maximum amount of production on which a credit may be claimed is 1,095 barrels or barrel equivalents.

The credit is not available if the reference price of oil exceeds $18 ($2.00 for natural gas). The credit is reduced proportionately for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas).[914] Currently the credit is phased out completely.

In the case of production from a qualified marginal well which is eligible for the credit allowed under section 45K for the taxable year, no marginal well credit is allowable unless the taxpayer elects not to claim the credit under section 45K with respect to the well. The section 45K credit is currently expired with respect to qualified natural gas and oil production. The credit is treated as a general business credit. Unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year.

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[913] Secs. 43(b) and 45K(d)(2)(C).

[914] The dollar amounts for purposes of calculating the reduction in credit are adjusted for inflation for tax years beginning in a calendar year after 2005. Sec. 45I(b)(2)(B).

Expensing of intangible drilling costs (sec. 263(c))

The Code provides special rules for the treatment of intangible drilling and development costs ("IDCs"). Under these special rules, an operator or working interest owner[915] that pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs.[916]

IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Such work includes labor, fuel, repairs, hauling, and supplies which are used (1) in the drilling, shooting, and cleaning of wells; (2) in the clearing of ground, draining, road making, surveying, and geological works necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items that have a salvage value (such as pipes and casings) or items that are part of the acquisition price of an interest in the property.[917] They also do not include (1) the cost to operators payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and (2) amounts properly allocable to the cost of depreciable property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. In the case of a nonproductive well ("dry hole"), IDCs may be deducted at the election of the operator.[918] For an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.[919]

Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or

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[915] An operator or working interest owner is defined as a person that holds an operating or working interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting operating or working rights.

[916] Sec. 263(c).

[917] Treas. Reg. sec. 1.612-4(a).

[918] Treas. Reg. sec. 1.612-4(b)(4).

[919] Sec. 291(b)(1)(A). The IRS has ruled that, if a company that has capitalized and begun to amortize IDCs over a 60-month period pursuant to section 291 ceases to be an integrated oil company, it may not immediately write off the unamortized portion of the capitalized IDCs, but instead must continue to amortize the IDCs so capitalized over the 60-month amortization period. Rev. Rul. 93-26, 1993-1 C.B. 50.

incurred.[920] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax ("AMT").

The election to deduct IDCs applies only to those IDCs associated with domestic properties.[921] For this purpose, the United States includes certain wells drilled offshore.[922]

Pursuant to a special exception, the uniform capitalization rules do not apply to IDCs incurred with respect to oil or gas wells that are otherwise deductible under the Code.[923]

Deduction for qualified tertiary injectant expenses (sec. 193)

Taxpayers engaged in petroleum extraction activities may generally deduct qualified tertiary injectant expenses paid or incurred in connection with a tertiary recovery method, including carbon dioxide augmented waterflooding and immiscible carbon dioxide displacement.[924] The deduction is available even if such costs are otherwise subject to capitalization. The deduction is permitted for the later of--(1) the tax year in which the injectant is injected or (2) the tax year in which the expenses are paid or incurred.[925] No deduction is permitted for expenditures for which a taxpayer has elected to deduct such costs under section 263(c) (intangible drilling costs) or if a deduction is allowed for such amounts under any other income tax provision.[926]

A "qualified tertiary injectant expense" is defined as any cost paid or incurred for any tertiary injectant (other than a recoverable hydrocarbon injectant) which is used as part of a

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[920] Sec. 59(e)(1).

[921] In the case of IDCs paid or incurred with respect to an oil or gas well located outside of the United States, the costs, at the election of the taxpayer, are either (1) included in adjusted basis for purposes of computing the amount of any deduction allowable for cost depletion or (2) capitalized and amortized ratably over a 10-year period beginning with the taxable year such costs were paid or incurred (sec. 263(i)).

[922] The term "United States" for this purpose includes the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources (i.e., the Continental Shelf area) (sec. 638).

[923] Sec. 263A(c)(3).

[924] Sec. 193. Prior to the enactment of section 193, the income tax treatment of tertiary injectant costs was unclear. In enacting section 193, Congress sought to clarify the tax treatment and encourage the use of qualified tertiary injectants. See, e.g., Joint Committee on Taxation, *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980* (JCS-1-81), January 29, 1981, pp. 114-115.

[925] Treas. Reg. sec. 1.193-1.

[926] Sec. 193(c).

tertiary recovery method.[927] The cost of a recoverable hydrocarbon injectant (which includes natural gas, crude oil and any other injectant with more than an insignificant amount of natural gas or crude oil) is not a qualified tertiary injectant expense unless the amount of the recoverable hydrocarbon injectant in the qualified tertiary injectant is insignificant.[928]

Expensing of mining exploration and development costs

A taxpayer generally must capitalize costs that benefit future periods, including certain direct and indirect costs of producing inventory or property used in the taxpayer's business.[929] Capitalized costs may be recovered through depreciation, depletion, cost of goods sold, or upon abandonment or other disposition. However, special rules apply with respect to mining exploration and development costs.[930]

Exploration costs

Taxpayers generally may elect to deduct amounts paid or incurred during the tax year in ascertaining the existence, location, extent, or quality of any deposit of ore, provided the amounts are paid or incurred prior to the beginning of the development stage of the mine.[931] The development stage of a mine typically begins when, based on all relevant facts and circumstances, deposits of ore or other minerals are demonstrated to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.[932] Generally, if mining exploration costs are not expensed, but are capitalized, they may be recovered through depletion or deducted as a loss if the exploration does result in the acquisition of productive property. For a corporation that has elected to expense mining exploration costs, 30 percent of the exploration costs must be capitalized and amortized over a 60-month period.[933]

Expenditures for the acquisition or improvement of depreciable property may not be deducted under the election; however, depreciation is considered as an eligible expenditure. The election may not be made only with respect to any oil or gas deposit or any mineral deposit for

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[927] Sec. 193(b). A tertiary recovery method is any of the nine methods described in section 212.78(c)(1) - (9) of the June 1979 energy regulations, as defined in former section 4996(b)(8)(C), or any other method approved by the IRS.

[928] Sec. 193(b)(2). Treas. Reg. sec. 1.193-1(c)(3) provides that an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

[929] Secs. 263 and 263A.

[930] Secs. 616 and 617.

[931] Sec. 617(a).

[932] Treas. Reg. sec. 1.617-1(a).

[933] Sec. 291(b)(1)(B).

which a deduction for percentage depletion is not permitted under section 613.[934] Expenditures paid or incurred with respect to mineral deposits located outside of the United States are not eligible for the election, but may, at the election of the taxpayer, be included in depletable basis or, if no such election is made, be deducted ratably over the 10-year period beginning with the taxable year in which the expenditures are paid or incurred.[935]

Expenditures expensed pursuant to the election are subject to recapture when the mine reaches the producing stage.[936] The recapture generally is accomplished through the disallowance of depletion with respect to the mining property that contains the mine until the expensed amounts are recaptured. A taxpayer may instead elect to include in gross income "adjusted exploration expenditures" for all mines reaching the producing stage during the taxable year.[937] Adjusted exploration expenditures are the amounts for which the taxpayer claimed a deduction under section 617 that would have been included in the basis of the property reduced by the excess of the percentage depletion over the depletion allowable under section 611 had the amounts been capitalized.[938]

Notwithstanding the fact that a taxpayer has made the election to deduct mining exploration costs, the taxpayer is allowed to capitalize and amortize such costs over a 10-year period beginning with the month the expenditure was paid or incurred.[939] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its mining exploration costs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the mining exploration adjustments or preferences under the alternative AMT.

The uniform capitalization rules under section 263A do not apply to mining exploration costs otherwise deductible under section 617.[940]

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[934] Sec. 617(a).

[935] Sec. 617(h). For these purposes, the United States includes the 50 states and the District of Columbia, as well as the Continental Shelf Areas adjacent to U.S. territorial waters and over which the United States has exclusive rights regarding exploration and exploitation of natural resources. See, S. Rep. No. 313, 99th Cong., 2d Sess. 282 (1986).

[936] Sec. 617(b).

[937] Sec. 617(b)(1).

[938] Sec. 617(f).

[939] Sec. 59(e)(1). See also, section 56(a)(7), which provides that mining exploration and development costs generally are capitalized and amortized ratably over 10 years beginning in the year the costs are paid or incurred for AMT purposes.

[940] Sec. 263A(c)(3).

Development costs

In general, expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) are expensed if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.[941] Development expenditures are amounts paid or incurred after deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.[942]

A taxpayer may elect to treat mining development expenditures paid or incurred during the taxable year as deferred expenses and recognize such amounts ratably as the units of produced ore or minerals benefited by such expenditures are sold. Special rules apply in the case of expenditures paid or incurred during the development stage of the mine that limit the election to the excess of the expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from the mine.

Depreciable property may not be expensed or treated as a deferred expense under section 616, but depreciation may be considered a development expenditure.[943] Expenditures with respect to the development of a mine or other natural deposit (other than an oil, gas, or geothermal well) located outside of the United States are deducted ratably over the 10-taxable-year period beginning with the year the expenditures are paid or incurred unless the taxpayer elects to include the expenditures in the depletable basis of the property.[944]

Rules similar to those discussed above with respect to exploration costs apply to limit the deduction for development expenditures for corporations. Thus, a corporation that expenses mining development costs must capitalize 30 percent of the costs and amortize the capitalized costs over a 60-month period.[945] Like mining exploration costs, mining development costs deductible under section 616 are not subject to the uniform capitalization rules under section 263A.[946] Additionally, the special 10-year election under section 59(e) is available for mining development costs to mitigate or eliminate the effect of the AMT preference or adjustment.[947]

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[941] Sec. 616(a).

[942] Treas. Reg. sec. 1.616-1(a).

[943] Sec. 616(a).

[944] Sec. 616(d).

[945] Sec. 291(b)(1)(B).

[946] Sec. 263A(c)(3).

[947] Sec. 59(e)(1). See also, section 56(a)(7), which provides that mining exploration and development costs generally are capitalized and amortized ratably over 10 years beginning in the year the costs are paid or incurred for AMT purposes.

Amortization period for geological and geophysical costs (sec. 167(h))

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.[948] G&G costs incurred by independent producers and smaller integrated oil companies[949] in connection with oil and gas exploration in the United States may generally be amortized over two years.[950]

Major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007 (the date of enactment of the Energy Independence and Security Act of 2007 ("EISA")).[951] A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property, but instead must continue to be amortized over the remaining applicable amortization period.

Percentage depletion (secs. 613 and 613A)

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income.[952] Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction. These include the cost of acquiring the lease or other interest in the property.

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[948] Geological and geophysical costs include expenditures for geologists, seismic surveys, gravity meter surveys, and magnetic surveys.

[949] In general, integrated oil companies are oil and gas producers that sell more than $5 million of retail product per year or refine more than 75,000 barrels of oil per year.

[950] This amortization rule applies to G&G costs incurred in taxable years beginning after August 8, 2005, the date of enactment of the Energy Policy Act of 2005, Pub. L. No. 109-58. Prior to the effective date, G&G costs associated with productive properties were generally deductible over the life of such properties, and G&G costs associated with abandoned properties were generally deductible in the year of abandonment.

[951] Pub. L. No. 110-140. Prior to the enactment of the Energy Independence and Security Act of 2007, major integrated oil companies were required to amortize G&G costs paid or incurred after May 17, 2006 over five years, as provided in Energy Tax Incentives Act of 2005.

[952] In the context of mineral extraction, depreciable assets are generally used to recover depletable assets. For example, natural gas gathering lines, used to collect and deliver natural gas, have a class life of 14 years and a depreciation recovery period of seven years.

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital. Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit, however, does not acquire an economic interest merely by possessing an economic or pecuniary advantage derived from production through a contractual relation.

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[953] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, a percentage, varying from five percent to 22 percent, of the taxpayer's gross income from a producing property is allowed as a deduction in each taxable year.[954] The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[955] Such producers and royalty owners may generally claim percentage depletion at a rate of 15 percent.[956]

The amount deducted generally may not exceed 50 percent (100 percent in the case of oil and gas properties) of the taxable income from the property in any taxable year.[957] Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).[958] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property,

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[953] Secs. 611 - 613.

[954] Sec. 613.

[955] Sec. 613A(c).

[956] Sec. 613A(c)(1).

[957] Sec. 613(a). For marginal production, discussed *infra*, this limitation is suspended for taxable years beginning after December 31, 1997, and before January 1, 2008 and for taxable years beginning after December 31, 2008 and before January 1, 2012.

[958] Sec. 613A(d)(1).

cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.[959]

A taxpayer is required to determine the depletion deduction for each property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question.[960]

Limitation on oil and gas percentage depletion to independent producers and royalty owners

As stated above, percentage depletion of oil and gas properties generally is not permitted, except for independent producers and royalty owners, certain fixed-price gas contracts, and natural gas from geopressured brine. For purposes of the percentage depletion allowance, an independent producer is any producer that is not a "retailer" or "refiner." A retailer is any person that directly, or through a related person, sells oil or natural gas (or a derivative thereof): (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or a derivative thereof) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person.[961]

Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales. Further, if the combined gross receipts of the taxpayer and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year, the taxpayer will not be treated as a retailer.

A refiner is any person that directly or through a related person engages in the refining of crude oil in excess of an average daily refinery run of 75,000 barrels during the taxable year.[962]

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.[963] For producers of both oil and natural gas, this limitation applies on a combined basis. All production

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[959] In the case of iron ore and coal (including lignite), a corporate preference reduces the amount of percentage depletion calculated by 20 percent of the amount of percentage depletion in excess of the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Sec. 291(a)(2).

[960] Sec. 613(a).

[961] Sec. 613A(d)(2).

[962] Sec. 613A(d)(4).

[963] Sec. 613A(c).

owned by businesses under common control and members of the same family must be aggregated;[964] each group is then treated as one producer in applying the 1,000-barrel limitation.

In addition to independent producers and royalty owners, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), if an interest in a proven oil or gas property was transferred (subject to certain exceptions), the production from such interest did not qualify for percentage depletion.[965] The 1990 Act repealed the limitation on claiming percentage depletion on transferred properties effective for property transfers occurring after October 11, 1990.

Percentage depletion on marginal production

The 1990 Act also created a special percentage depletion provision for oil and gas production from so-called marginal properties held by independent producers or royalty owners.[966] Under this provision, the statutory percentage depletion rate is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than $20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The increased rate applies for the taxpayer's taxable year that immediately follows a calendar year for which the average crude oil price falls below the $20 floor. To illustrate the application of this provision, the average price of a barrel of crude oil for calendar year 1999 was $15.56. Thus, the percentage depletion rate for production from marginal wells was increased to 19 percent for taxable years beginning in 2000. Since the price of oil currently is above the $20 floor, there is no increase in the statutory depletion rate for marginal production.

The Code defines the term "marginal production" for this purpose as domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less, corrected to 60 degrees Fahrenheit).[967] A stripper well property is any oil or gas property that produces a daily average of 15 or fewer

[964] Sec. 613A(c)(8).

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

[966] Sec. 613A(c)(6).

[967] Sec. 613A(c)(6)(D).

equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.[968]

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, a taxpayer makes the stripper well property determination for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's interest. If the property satisfies the requirements of a stripper well property, then the benefits of this provision apply with respect to the taxpayer's allocable share of the production from the property. The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

Percentage depletion for hard mineral fossil fuel properties

Percentage depletion is available for taxpayers with an economic interest in a coal mine or other hard mineral fossil fuel property such as lignite or oil shale properties. The depletion rate for coal and lignite is 10 percent.[969] For oil shale, the rate generally is 15 percent, but the rate drops to 7.5 percent for shale used or sold for use in the manufacture of sewer pipe or brick or as sintered or burned lightweight aggregates.[970]

As noted above, the percentage depletion deduction is limited to 50 percent of the taxable income from the property (determined before depletion and the deduction under section 199). Additionally, a corporation's percentage depletion deduction with respect to coal or lignite properties is reduced by 20 percent of the excess of the percentage depletion deduction over the

[968] Sec. 613A(c)(6)(E).

[969] Sec. 613(b)(4).

[970] Sec. 613(b)(2)(B) and (5).

adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year).[971]

The excess of percentage depletion over cost depletion is a tax preference in computing a taxpayer's AMTI.[972]

Deduction for income attributable to domestic production of oil and gas, coal, and other hard mineral fossil fuels

Section 199 of the Code provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the lesser of a taxpayer's taxable income or its qualified production activities income.[973] In general, for taxable years beginning after 2009, the deduction is nine percent of such income. With respect to a taxpayer that has oil related qualified production activities income for taxable years beginning after 2009, the deduction is limited to six percent of the least of its oil related production activities income, its qualified production activities income, or its taxable income.[974]

A taxpayer's deduction under section 199 for a taxable year may not exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[975]

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[971] Sec. 291(a)(2).

[972] Sec. 57(a)(1).

[973] In the case of an individual, the deduction is equal to a portion of the lesser of the taxpayer's adjusted gross income or its qualified production activities income. For this purposes, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the section 199 deduction.

[974] "Oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas or any primary product thereof (as defined in section 927(a)(2)(C) prior to its repeal). Treas. Reg. sec. 1.927(a)-1T(g)(2)(i) defines the term "primary product from oil" to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil. Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii) defines the term "primary product from gas" as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii) provides that these primary products and processes are not intended to represent either the only primary products from oil or gas or the only processes from which primary products may be derived under existing and future technologies. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv) provides as examples of non-primary oil and gas products petrochemicals, medicinal products, insecticides, and alcohols.

[975] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; and (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States;[976] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;[977] or (5) engineering or architectural services performed in the United States with respect to the construction of real property in the United States.

Drilling oil or gas wells

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.[978] Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of Treas. Reg. sec. 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.[979]

Qualifying in-kind partnerships

In general, an owner of a pass-through entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for "qualifying in-kind partnerships," which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or

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[976] Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

[977] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

[978] Treas. Reg. sec. 1.199-3(m)(1)(i).

[979] Treas. Reg. sec. 1.199-3(m)(2)(iii).

products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[980] In the case of a qualifying in-kind partnership, each partner is treated as having MPGE property to the extent such property is distributed by the partnership to that partner.[981] If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE activities previously conducted by the qualifying in-kind partnership with respect to that property.[982]

Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing AMTI (including adjusted current earnings). The deduction in computing AMTI is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the AMTI (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Exception from passive loss rules for working interests in oil and gas property (sec. 469)

The passive loss rules limit deductions and credits from passive trade or business activities.[983] A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.[984] Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

Losses from certain working interests in oil and gas property are not limited under the passive loss rule.[985] Thus, losses and credits from such interests can be used to offset other income of the taxpayer without limitation under the passive loss rule. Specifically, a passive

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[980] Treas. Reg. sec. 1.199-9(i)(2).

[981] Treas. Reg. sec. 1.199-9(i)(1).

[982] *Ibid*.

[983] Sec. 469. These rules were enacted in 1986 to curtail tax shelters. They apply to individuals, estates and trusts, and closely held corporations.

[984] Regulations provide more detailed standards for material participation. See Treas. Reg. sec. 1.469-5 and -5T.

[985] Sec. 469(c)(3). See also Treas. Reg. sec. 1.469-1T(e)(4).

activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity. If the taxpayer has a loss from a working interest in any oil or gas property that is treated as not from a passive activity, then net income from the property for any succeeding taxable year is treated as income of the taxpayer that is not from a passive activity.

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property. Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision. Thus, for purposes of the passive loss rules, an interest owned by a limited partnership is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder. The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form.

When an interest is not treated as a working interest because the taxpayer's form of ownership limits his liability, the general rules regarding material participation apply to determine whether the interest is treated as a passive activity. Thus, for example, a limited partner's interest generally is treated as in a passive activity. In the case of a shareholder in an S corporation, the general facts and circumstances test for material participation applies and the working interest exception does not apply, because the form of ownership limits the taxpayer's liability.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, e.g., property acquired in a sec. 1031 like kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.

Capital gains treatment of certain coal royalties

Royalties generally are taxed as ordinary income for Federal income tax purposes. However, the Code provides a special rule that treats royalties from certain dispositions of coal as capital gains. Specifically, in the case of the disposal of coal (including lignite) mined in the United States, held for more than one year prior to disposal, by the owner in a form under which

the owner retains an economic interest in such coal, the excess of the amount realized from the sale over the adjusted depletable basis of the coal plus certain disallowed deductions is treated as the sale of depreciable property used in the owner's trade or business (i.e., the sale of section 1231 property).[986] For these purposes, an owner means any person who owns an economic interest in coal in place, including a lessee or sublessor thereof.[987] Section 631(c) does not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal.[988]

Section 1231 generally provides that if recognized gains on the sale or exchange of property used in a taxpayer's trade or business,[989] plus certain gains on involuntary conversions, exceed losses from such sales, exchanges, or conversions, the gain is long-term capital gain.[990] If losses exceed gains, the losses are treated as ordinary losses. The net ordinary losses are subject to certain recapture provisions. Thus, if the owner's section 1231 gains, including royalties from coal disposals described in section 631(c), exceed its section 1231 losses, the royalties will be treated as long-term capital gains.

Section 631(c) is not elective. Thus, if a taxpayer meets the requirements of the section, royalties from the disposal of coal will be treated as the disposition of section 1231 property. An owner may not claim percentage depletion with respect to coal that is subject to section 631(c) if for the taxable year of the sale the maximum tax rate for capital gains or losses is less than the maximum tax rate for ordinary income.[991]

Description of Proposal

The proposal repeals (1) the enhanced oil recovery credit, (2) the marginal wells credit, (3) the expensing and 60-month amortization of IDCs, (4) the deduction for tertiary injectants,[992]

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[986] Secs. 631(c) and 1231(b)(2).

[987] Sec. 631(c).

[988] *Ibid*.

[989] Property used in the trade or business generally means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than one. Section 1231 property does not include inventory or property held for sale to customers in the ordinary course of the taxpayer's business. However, section 1231 property includes coal to which section 631 applies, even if such coal is held as inventory or for sale to the taxpayer's customers in the ordinary course of the taxpayer's business.

[990] Special recapture rules apply for non-recaptured section 1231 losses. See section 1231(d).

[991] Under section 631(c) royalty income is reduced by the adjusted depletion basis of the coal disposed of plus administrative costs disallowed under section 272. The adjusted depletion basis is the same amount as would have been the cost depletion allowance under section 612.

[992] If section 193 were repealed, the treatment of tertiary injectant expenses would revert to prior law and might include capitalization and recovery through depreciation, capitalization and recovery as consumed (e.g., as a supply), or deduction as loss in the year of abandonment or the year production benefits ceased. Amounts expensed as depreciation, depletion, or supplies may be subject to capitalization under section 263A. See, e.g., Treas. Reg. sec. 1.263A-1(e)(3).

(5) the exception for passive losses from working interests in oil and gas properties, (6) percentage depletion for oil and gas, coal (including lignite), and certain oil shale, (7) expensing and 60-month amortization of mining exploration and development costs for coal (including lignite) and certain oil shale, (8) the domestic manufacturing deduction for income derived from the domestic production of oil, gas, coal (including lignite), and certain oil shale, or primary products thereof, and (9) capital gains treatment for certain coal (including lignite) royalties. With respect to IDCs and mining exploration and development costs, the proposal requires that such costs be capitalized and recovered through depletion or depreciation, as applicable.

The proposal also increases the amortization period for G&G costs of independent and non-integrated producers from two to seven years. The seven-year amortization period would apply even if the property is abandoned such that any remaining unrecovered basis of the abandoned property would continue to be recovered over the remainder of the seven-year period.

Effective date.−The repeal of the enhanced oil recovery credit, the marginal wells credit, the exception for passive losses from working interests in oil and gas properties, percentage depletion for oil, gas, coal, and other hard mineral fossil fuels, and the domestic manufacturing deduction for the production of oil, gas, coal, or other hard mineral fossil fuels is effective for taxable years beginning after December 31, 2011. The repeal of expensing and 60-month amortization of IDCs, the repeal of the deduction for tertiary injectant costs, the increased amortization period for G&G expenses, and the repeal of expensing and 60-month amortization for coal and oil shale mining exploration and development costs are effective for amounts paid or incurred after December 31, 2011. The repeal of capital gains treatment for certain coal royalties is effective for amounts realized in taxable years beginning after December 31, 2011.

Analysis

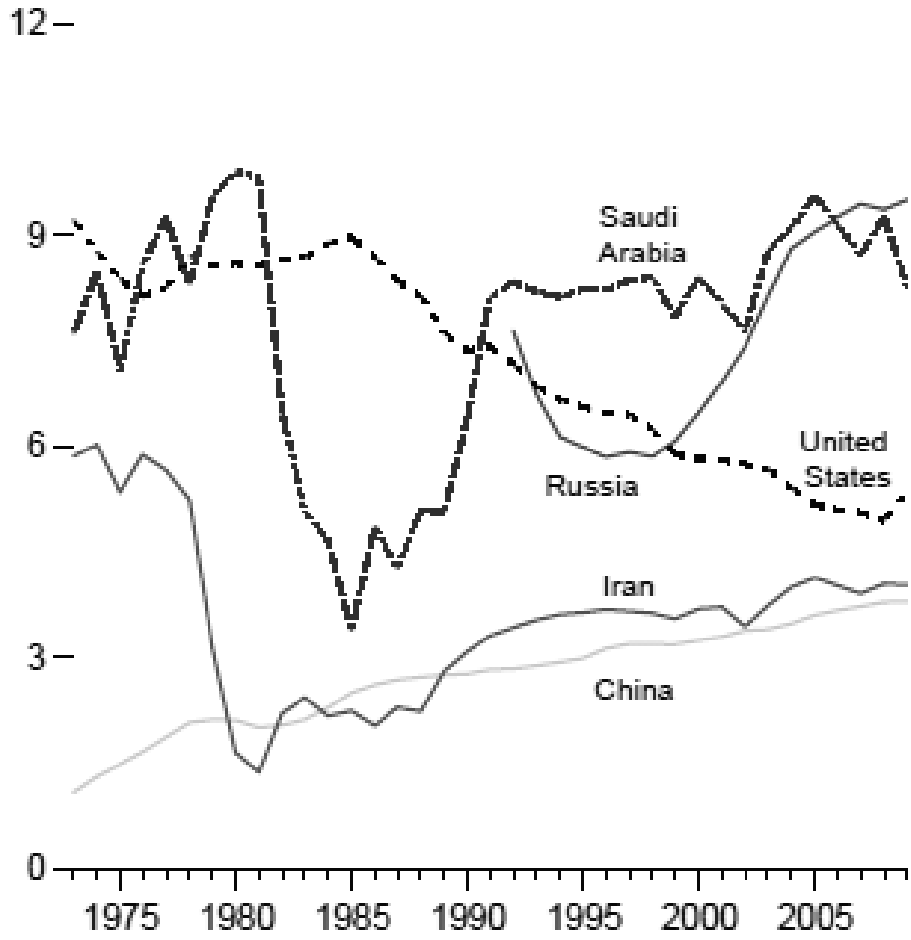
Overview of domestic oil, natural gas, and coal production

Oil and natural gas production

Despite having less than two percent of the world's oil reserves,[993] the United States remains one of the largest oil producers in the world.

[993] Energy Information Administration, *International Energy Outlook* 2010, July 27, 2010, Table 5.

Figure 2.−Crude Oil Production in Selected Countries
(millions of barrels per day)



Source: Energy Information Administration, Monthly Energy Review, February 2011, Figure 11.1a.

Although domestic oil production has declined steadily since the mid-1980s, domestic oil production is predicted to increase over the next twenty years, with most of the near-term increase resulting from deepwater offshore drilling.[994] Domestic onshore crude oil production is also projected to increase, primarily as the result of increased application of carbon dioxide-enhanced oil recovery techniques and the startup of liquids production from oil shale.[995]

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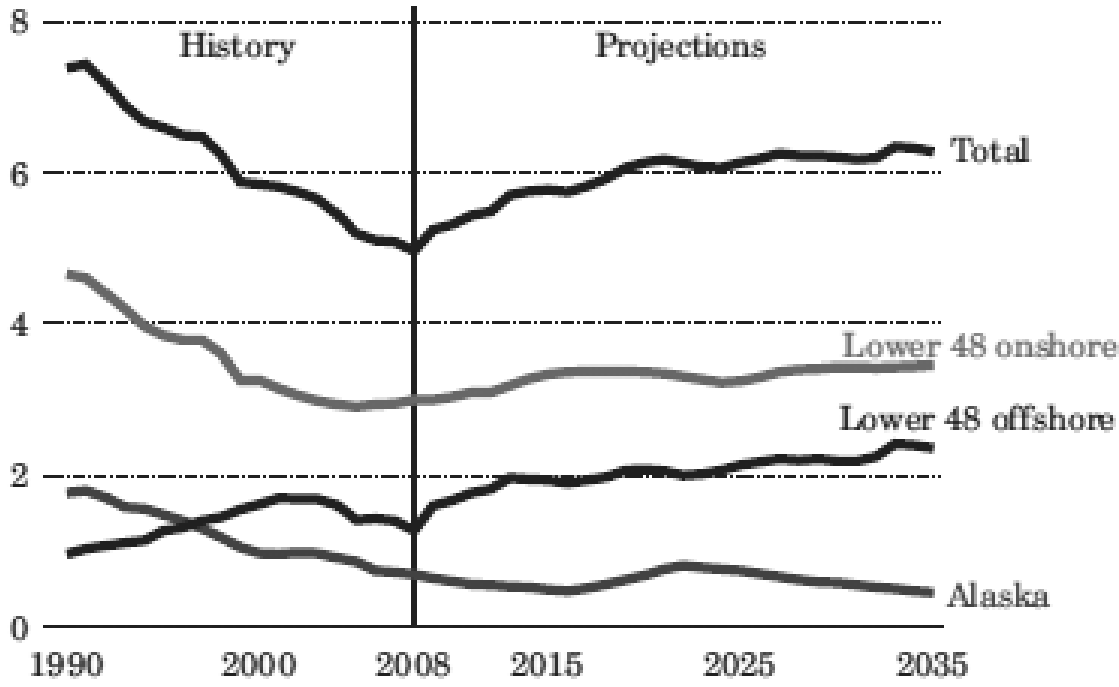
[994] Energy Information Administration, *Annual Energy Outlook 2010*, April 2010, p. 75.

[995] *Ibid.*

Figure 3.−Projected Domestic Crude Oil Production by Source, 1990-2030
(millions of barrels per day)



Source: Energy Information Administration, Annual Energy Outlook 2010, April 2010, Figure 80, p. 75.

Because the remaining domestic oil reserves generally require more costly secondary or tertiary recovery techniques, domestic crude oil production is highly sensitive to world crude oil prices.[996]

The United States has a slightly larger share of the world's natural gas reserves compared to oil reserves but it still amounts to less than four percent of the global total.[997] Like oil, however, domestic production of natural gas is expected to increase, with most of the increase attributable to onshore unconventional production (such as natural gas produced from tight sand and shale formations).[998]

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[996] *Ibid.*

[997] Energy Information Administration, *International Energy Outlook* 2010, July 27, 2010, Table 7.

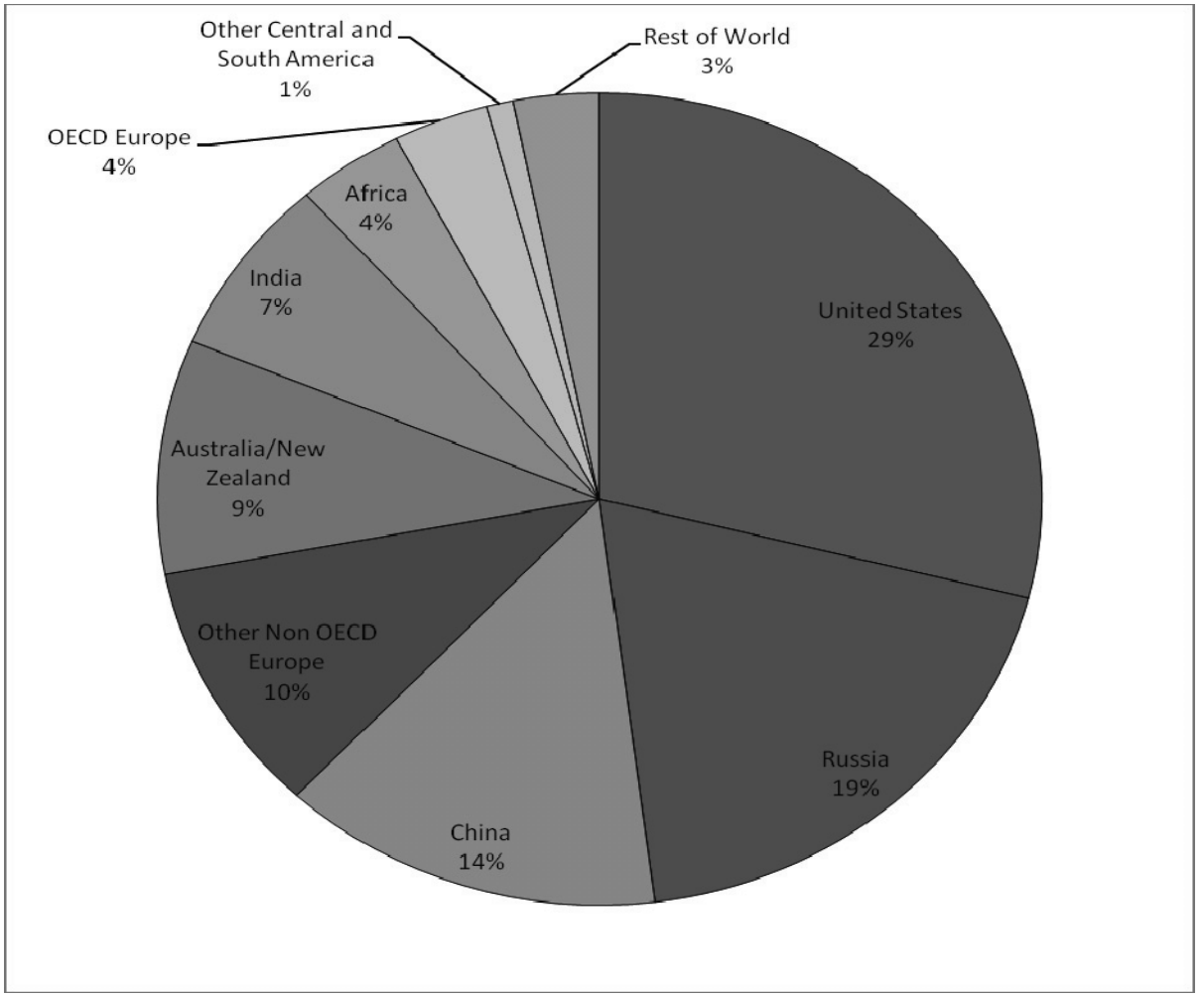
[998] Energy Information Administration, *Annual Energy Outlook 2009*, April 2010, pp. 3, 75.

The oil and gas industry continues to be a large employer in the United States. For 2010, the domestic oil and gas extraction sector employed a seasonally adjusted average of 165,400 workers.[999]

Coal production

As with oil, the United States is one of the biggest producers of coal in the world.[1000] Unlike with oil, however, and as illustrated below, the United States has by a substantial margin the world's largest coal reserves.

Figure 4.−Estimated World Coal Reserves by Country



Source: Generated using data from the Energy Information Administration, *International Energy Outlook* 2010, July 27, 2010, Table 10.

[999] Bureau of Labor Statistics, *Monthly Labor Review*, vol. 134, no. 2, February 2011, Table 12, p. 72.

[1000] The United States is the world's second largest producer of coal after China. Energy Information Administration, *International Energy Outlook 2010*, July 27, 2010, Table 8.

Domestic coal production is projected to grow slowly over the next 20 years.[1001]

The coal mining sector continues to be a major source of jobs in the United States. For 2010, the coal mining sector employed a seasonally adjusted average of 82,900 workers.[1002]

History of specific oil and gas provisions

The tax rules governing oil and gas production have undergone numerous changes over the past half century. The following table lists the major changes to the provisions whose repeal has been proposed.

Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities			
Year	**Act**	**Code Section**	**Description of Modification**
1969	Tax Reform Act of 1969 (Pub. L. No. 91-172)	613(b)	Percentage depletion rates for oil and gas wells decreased from 27.5 percent to 15 percent.
1975	Tax Reduction Act of 1975 (Pub. L. No. 94-12)	613A	Percentage depletion eliminated for integrated oil and gas companies; taxable income limitation to independent producers and royalty owners claiming percentage depletion added to the Code.
1980	Crude Oil Windfall Profit Tax Act of 1980 (Pub. L. No. 96-223)	193	Deduction for qualified tertiary injectant expenses added to the Code.
1982	Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)	291(b)	Provision requiring amortization over 36 months of 15 percent of intangible drilling costs (IDCs) not currently deductible by integrated oil and gas companies added to the Code.
1984	Deficit Reduction Act of 1984 (Pub. L. No 98-369)	291(b)	IDC capitalization percentage increased from 15 percent to 20 percent.

[1001] Energy Information Administration, *Annual Energy Outlook 2010*, April 2010, p. 79.

[1002] Bureau of Labor Statistics, *Monthly Labor Review*, vol. 134, no. 2, February 2011, Table 12, p. 72.

Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities			
Year	**Act**	**Code Section**	**Description of Modification**
1986	Tax Reform Act of 1986 (Pub. L. No. 99-514)	291(b)	IDC capitalization percentage increased to 30 percent and extended the amortization period to 60 months
		469(c)(3)	Provision excluding working interests in oil and gas property from the definition of a passive activity for purposes of the limitation on passive activity losses added to the Code.
1990	Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508)	43	Enhanced oil recovery credit added to the Code.
		613	Maximum percentage depletion allowance for oil and gas properties increased from 50 percent to 100 percent of income from the property.
1997	Taxpayer Relief Act of 1997 (Pub. L. No. 105-34)	613A	Temporary suspension of taxable income limit for marginal production.[1]
2004	American Jobs Creation Act of 2004 (Pub. L. No. 108-357)	45I	Marginal wells credit added to the Code.
		199	Deduction for domestic production activities (including domestic oil and gas production) added to the Code.
2005	Energy Policy Act of 2005 (Pub. L. No. 109-58)	167(h)	Two-year amortization of geological and geophysical (G&G) costs added to the Code. Prior to this, G&G costs incurred with respect to abandoned sites could be expensed, while G&G costs associated with producing wells had to be recovered over the life of the well.
2006	Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222)	167(h)	Two-year amortization period of G&G costs extended to five years for major integrated oil companies.
2007	Energy Independence and Security Act of 2007 (Pub. L. No. 110-140)	167(h)	Five-year amortization period of G&G costs extended to seven years for major integrated oil companies.
2008	Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343)	199	Capped the section 199 deduction percentage for oil related qualified production activities at six percent for taxable years beginning after 2009.

[1] This temporary suspension has been extended multiple times, most recently through December 31, 2011, by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312).

As the table makes apparent, Congressional action with respect to domestic oil and gas production incentives has varied over time. With some exceptions, during the 1970s and 1980s, the trend of Congressional action was to reduce or limit the tax benefits available to oil and gas producers. During the 1990s and the early part of the last decade, the trend reversed direction and favored expanded incentives. More recently, Congress has begun reducing incentives once again. In the broadest sense, these trends tend to coincide with periods of high and low oil prices.

History of specific coal provisions

Chronology of Major Post-1954 Tax Law Changes Affecting Coal Production Activities			
Year	**Act**	**Code Section**	**Description of Modification**
1982	Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)	291(b)	Provision requiring designated percentage (15-21 percent) of mining exploration and development costs to be capitalized and recovered ratably over five year taxable years added to the Code.
1986	Tax Reform Act of 1986 (Pub. L. No. 99-514)	291(b)	Mining exploration and development cost capitalization percentage increased to 30 percent and amortization period of 60 months.
		616(d)	Foreign development costs required to be capitalized and either depleted, or amortized over 10 years.
		617(h)	Foreign exploration costs required to be capitalized and either depleted, or amortized over 10 years.
2004	American Jobs Creation Act of 2004 (Pub. L. No. 108-357)	199	Deduction for domestic production activities (including domestic coal production) added to the Code.

As is evident in the table, there has been relatively little Congressional action with respect to domestic coal production incentives. The most recent legislation changes have been to limit coal preferences to domestic production.

Effect of repealing fossil fuel production incentives

A common rationale for favorable tax treatment of certain activities (tax credits or other forms of subsidy), or unfavorable treatment (taxes), is that there exist externalities in the consumption or production of certain goods. An externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole. When the social costs of consumption or production exceed

the private costs of consumption or production, a negative externality exists. For example, the private cost of driving a badly-out-of-tune car is just the extra gasoline or oil required, but the social cost also includes all of the extra pollution that it creates. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over-consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under-consumption and under-production of the good producing the positive externality. The reason for the over-consumption or under-consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption and production, because in this case private costs and benefits will be equal to social costs and benefits.

As mentioned above, pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, one intervention that could produce a more socially desirable level of pollution would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. In the case of a positive externality, an appropriate economic policy would be to impose a negative tax (i.e. a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production. The favorable tax treatment accorded fossil fuel industries represents other, less direct, means of subsidizing an activity through the tax code by reducing the tax burden on capital employed in the sector, thus encouraging more capital to be employed in that sector of the economy.

Many observers today would agree that there are negative externalities to the consumption of fossil fuels, including both pollution and increased dependence on foreign sources of oil. For this reason, many feel that fossil fuels should be taxed more heavily rather than granted certain favorable treatment in the Code. Repealing incentives for fossil fuel production would increase the after-tax costs associated with these activities, likely reduce the amount of capital employed in these activities in the long run, and potentially increase the prices of fossil fuels.[1003] If fossil fuel prices were to rise as the result of the repeal of incentives for

[1003] Any price rise is likely to be attenuated in the case of a globally traded commodity, such as oil, where the price is determined globally. In such a case, a decrease in United States' output may have a greater effect increasing imports of foreign oil than on increasing crude prices for domestic consumers. Similarly, an increase in United States' output may have a greater effect displacing imports of foreign oil than on decreasing crude prices for domestic consumers.

fossil fuel production, there could be substitution from fossil fuels and into other energy sources, including nuclear or renewable sources of energy. The impact on pollution of any such substitution is unclear and would depend on the type and quantity of pollution associated with the alternative energy resource. To the extent that addressing pollution concerns was a major objective, economic theory would suggest the need for a tax on the externality from the consumption of fossil fuels that equaled the social cost from the consumption. Simply removing selected subsidies related to the production of fossil fuels does not address the issue of establishing proper prices on the consumption of goods that cause pollution.

If the proposals caused substitution into alternative sources of energy, reliance on foreign sources of fossil fuels could be reduced because nuclear and renewable energy sources are domestically produced.[1004] Alternatively, to the extent that the proposals primarily affect domestic production of fossil fuels, it is possible that any substitution into these alternate energy sources reflects a substitution from domestic production of fossil fuels into domestic production of these alternate sources, thus leaving the United States' reliance on foreign fossil fuels unchanged. Furthermore, as the proposals are likely to have no effect on the world price of fossil fuels, any increase in prices for domestically consumed fossil fuels is likely to be attenuated, and the proposals could primarily result in substitution of foreign fossil fuel sources for domestic sources whose production is more reliant on the subsidies provided in current law. Such an outcome would further imply that the proposals would not lead to any shift into the alternate energy sources of nuclear or renewables. Lastly, other observers have argued that current prices and expected future demand for fossil fuels provide sufficient market-based incentives for domestic exploration and production, and have argued that the present law subsidies are unnecessary to secure a viable domestic fossil fuels production industry.

Additional motivations may also support specific proposed changes. For example, with respect to tertiary injectants, opponents of repeal have also argued that the deduction for tertiary injectants encourages the use of carbon dioxide in enhanced oil recovery projects. Such projects represent a primary method of carbon sequestration, which reduces greenhouse gas emissions by capturing and storing carbon dioxide that would otherwise be released into the atmosphere.[1005] Proponents of the proposal might argue that encouraging carbon dioxide sequestration is better handled through incentives directly targeting carbon sequestration.

Another example is the exception to the passive loss rules for working interests in oil and gas properties, which in addition to providing an incentive to produce oil and gas, creates the potential to shelter income that would otherwise be taxable. It could be argued that tax sheltering has become an increasing problem in the Federal tax system as some of the base-broadening and rate-lowering changes made by the Tax Reform Act of 1986 have been reversed or modified by subsequent legislation. From a tax policy perspective (rather than an energy

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[1004] Much imported crude oil is used in the transportation sector, and little is used in electricity generation. The scope for renewables to displace fossil fuels is thus limited by the ability to produce and use transportation grade renewable fuels, or to displace fuel-based transportation with battery powered transportation.

[1005] See also sec. 45Q, which provides a credit for certain qualified tertiary injectant projects that use carbon sequestration.

policy perspective), some might argue that the perception of fairness in the tax system, as well as the need for improved horizontal equity among individual taxpayers, support repeal of the special tax benefits for oil and gas working interests.

Those in favor of retaining incentives for domestic production might argue that a healthy domestic fossil fuels production base serves national security goals, by reducing our dependence on foreign sources of oil. However, it can be argued that such reliance is more effectively addressed through a direct tax on imported oil or an import fee, which could encourage less consumption and promote the use of lower emission, renewable energy alternatives. Others might argue that in the current economic environment, eliminating the incentives might adversely affect employment in domestic fossil fuel production. Furthermore, the deduction for domestic production activities is a broadly available incentive for all domestic production industries, and thus does not bias investment in favor of the fossil fuels sector. Repealing the deduction for the fossil fuels sector alone would bias investment away from this sector.

Finally, it could be argued that some of the President's fossil fuels proposals might reintroduce administrative complexity currently absent under present law, such as in the case of the repeal of the deduction for tertiary injectants.

Prior Action

The proposals with respect to (1) the enhanced oil recovery credit, (2) the marginal wells credit, (3) the expensing and 60-month amortization of IDCs, (4) the deduction for tertiary injectants, (5) the exception for passive losses from working interests in oil and gas properties, (6) percentage depletion for oil and gas, and (7) the domestic manufacturing deduction for income derived from the domestic production of oil, gas, or primary products thereof were included in the President's budget for fiscal years 2010 and 2011.

The proposals with respect to (1) expensing and 60-month amortization of mining exploration and development costs for coal (including lignite) and certain oil shale, (2) the domestic manufacturing deduction for income derived from the domestic production of coal (including lignite), and certain oil shale, or primary products thereof, and (3) capital gains treatment for certain coal (including lignite) royalties were included in the President's budget for fiscal year 2011.

The proposal with respect to G&G expenses was included in the President's budget for fiscal years 2009, 2010, and 2011. Similar G&G proposals were also included in the President's budget proposals for fiscal years 2007 and 2008. The President's budget for fiscal year 2007 included a proposal to extend the G&G amortization period to five years for all producers. At the time, all domestic oil and gas producers (including major integrated oil companies) could amortize their G&G expenses over two years. Congress partially implemented the 2007 proposal by extending the G&G amortization period to five years for major integrated oil companies. The President's budget for fiscal year 2008 included a proposal to extend the G&G amortization period to five years for independent producers. At the time, independent producers could amortize their G&G expenses over two years while major integrated oil companies had to amortize their G&G expenses over five years. Congress did not implement the 2008 proposal but extended the amortization period to seven years for major integrated oil companies.

PART VII − SIMPLIFY THE TAX CODE

A. Plug-In Electric-Drive Motor Vehicle Credit

Present Law

A credit is available for each qualified plug-in electric-drive motor vehicle placed in service. A qualified plug-in electric-drive motor vehicle is a motor vehicle that has at least four wheels, is manufactured for use on public roads, is treated as a motor vehicle for purposes of title II of the Clean Air Act (that is, is not a low-speed vehicle), has a gross vehicle weight of less than 14,000 pounds, meets certain emissions standards, draws propulsion using a traction battery with at least four kilowatt-hours of capacity, and is capable of being recharged from an external source of electricity.

The base amount of the plug-in electric-drive motor vehicle credit is $2,500, plus another $417 for each kilowatt-hour of battery capacity in excess of four kilowatt-hours. The maximum credit is capped at $7,500.

In general, the credit is available to the vehicle owner, including the lessor of a vehicle subject to lease. If the qualified vehicle is used by certain tax-exempt organizations, governments, or foreign persons and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

Once a total of 200,000 credit-eligible vehicles have been sold by a manufacturer for use in the United States, the credit phases out over four calendar quarters beginning in the second calendar quarter following the quarter in which the manufacturer limit is reached. Taxpayers may claim one-half of the otherwise allowable credit during the first two calendar quarters of the phaseout period and twenty-five percent of the otherwise allowable credit during the next two quarters. After this, no credit is available.

The basis of any qualified vehicle is reduced by the amount of the credit. To the extent a vehicle is eligible for credit as a qualified plug-in electric-drive motor vehicle, it is not eligible for credit as a qualified hybrid vehicle under section 30B. The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as part of the general business credit; the nonbusiness portion of the credit is allowable to the extent of the excess of the regular tax over the alternative minimum tax (reduced by certain other credits) for the taxable year.

The credit is part of the general business credit and may be carried back by businesses one year or forward twenty years. However, unused credits allowable to individuals may not be carried back or carried forward.

Description of Proposal

The proposal allows the credit to the person selling the vehicle (or, at the election of the seller, to the person financing the sale), rather than to the person placing the vehicle in service.

The proposal requires that the seller or financier disclose to the purchaser the amount of the credit.

Effective date.−The proposal is effective for vehicles sold after December 31, 2011.

Analysis

Under present law, a number of taxpayers lack sufficient tax liability to utilize the full amount of the plug-in electric-drive motor vehicle credit. For 2011, only 19.9 percent of all non-dependent individual taxpayers had a tax liability equal to or exceeding $7,500 ($3,750 for married taxpayers filing separate returns), the maximum credit available for plug-in vehicles.

In addition, because unused credits allowable to individuals may not be carried back or carried forward to offset tax liabilities in other years, such credits may be worth less to individuals than to businesses. By shifting the credit to the seller of the vehicle, the full amount of the credit is more likely to be available because of carrybacks and carryforwards available to businesses.

One effect of the proposal may be greater utilization of the credit, to the extent that taxpayers in the business of selling vehicles are more likely to have sufficient tax liability to use the plug-in vehicle credits than individual taxpayers. This would be the case if such sellers are generally profitable and such profits result in tax liabilities that exceed the aggregate plug-in vehicle credits. While this seems likely in the case of an auto dealership that sells a wide variety of plug-in and traditional vehicles, it may be less likely where the dealership specializes in selling plug-in electric-drive motor vehicles. In such case, the credits may routinely exceed the tax liability of the seller. It is difficult to attain efficient credit utilization when one must rely on positive tax liability to obtain the full value of the credit.

One of the proposal's stated objectives is to allow buyers of plug-in vehicles to monetize the credit more rapidly.[1006] Individual taxpayers in many cases will not receive the value of the credit until after they file their tax returns, though they could take measures to receive the benefit of the credit more rapidly if they adjusted their wage withholding or estimated tax payments. By shifting the credit to the sellers, the economic value of the credit to the seller could be reflected in a reduced purchase price to the buyer. Thus, the buyer could receive the value of the credit at the time of sale, potentially providing a greater purchase incentive for some taxpayers.

Prior Action

No prior action.

[1006] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, p. 81.

B. Eliminate Required Minimum Distribution Rules for Balances of $50,000 or Less

Present Law

General rules

The minimum distribution requirements limit the tax deferral allowed for tax-advantaged retirement plans by requiring that distributions generally begin at age 70½ in order to ensure that these plans are used to provide funds for retirement. Specifically the requirements apply to individual retirement arrangements (IRAs) and employer-sponsored tax-qualified retirement plans, which include: (1) plans qualified under section 401(a), which are commonly known as "qualified plans" and which may include qualified cash or deferral arrangements (so called "section 401(k) plans"); (2) plans described in section 403(a), which are commonly referred to as "section 403(a) annuities" and are subject to most of the requirements applicable to tax-qualified retirement plans; (3) section 403(b) tax-deferred annuities, which may only be sponsored by certain types of tax-exempt employers; and (4) section 457(b) plans.[1007] In the case of employer-sponsored tax qualified retirement plans, subject to certain limits, contributions are made on an employee's behalf (or benefits accrue in the case of a defined benefit plan) during the employee's years of employment. Taxable employers are allowed a deduction for the contributions. The contributions generally are held in a tax-exempt trust or custodial account. The employees or beneficiaries generally are only taxed when amounts are actually distributed under the plan. For traditional IRAs, the taxpayer may be entitled to a deduction for the contributions but nondeductible contributions are also permitted. Amounts in an IRA are only taxable when actually distributed. In the case of Roth IRAs, distributions are tax-free if certain conditions are satisfied. IRAs (both traditional and Roth IRAs) generally are tax-exempt trusts or custodial accounts.

To ensure that the savings and benefits under these plans are retained for retirement, early withdrawals from IRAs or employer sponsored tax-qualified retirement plans (other than section 457(b) plans) generally are subject to an additional tax.[1008] The tax is calculated by reference to the amount of the distribution that is includable in adjusted gross income. Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent tax unless an exception applies. There are exceptions for withdrawals that are: due to death or disability; made in the form of certain periodic payments; used to pay medical expenses in excess of 7.5 percent of adjusted gross income; used to purchase health insurance of certain unemployed individuals; used for higher education expenses; used for first-time homebuyer expenses of up to $10,000; or made to a member of a reserve unit called to active duty for 180 days or longer.

Generally, the same minimum distribution requirements apply to IRAs and employer sponsored tax-qualified retirement plans. The lifetime rules require that annual minimum

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[1007] Section 457(b) plans take two forms, plans sponsored by tax-exempt organizations which are generally unfunded, and plans sponsored by State and local governments ("governmental section 457(b) plans"), for which contributions are made to a tax-exempt trust.

[1008] Sec. 72(t).

distributions begin no later than the "required beginning date." Under employer-sponsored tax-qualified retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires.[1009] For an employee who is a five percent owner under an employer-sponsored tax-qualified retirement plan in the year the employee attains age 70½, and under traditional IRAs, the required beginning date is April 1 following the calendar year in which the employee or IRA owner attains age 70½. For all plans and IRAs, to the extent that the required minimum amount for a year is not distributed, the distributee is subject to an excise tax equal to 50 percent of the difference between the amount distributed for the year and the amount that was required to be distributed.[1010]

Generally contributions continue to be made, or for a defined benefit plan, the employee continues to accrue benefits, while the employee continues to work for the employer after attaining age 70½. For IRAs, individuals are not permitted to make contributions after age 70½ to traditional IRAs but are permitted to make contributions to Roth IRAs.

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.[1011] If an employee or IRA owner dies after minimum required distributions have begun, which generally is interpreted in the regulations as on or after the required beginning date, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death.

If an employee or IRA owner dies before minimum distributions have begun, which generally is interpreted in the regulations as before the required beginning date, then the entire remaining interest of the employee or IRA owner must generally be distributed within five years of the individual's death. However, there is an alternative rule if any portion of the benefit is payable to a designated beneficiary. Under this rule, distributions are permitted to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary. There is a special application of this alternative rule if the designated beneficiary is the surviving spouse. In such case, distributions over the surviving spouse's life or life expectancy are not required to commence until the employee or IRA owner would have attained age 70 ½. If the surviving spouse dies before the employee or IRA owner would have attained age 70 ½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee or IRA owner.

[1009] Sec. 401(a)(9)(C).

[1010] Sec. 4974.

[1011] Sec. 401(a)(9)(A).

The regulations under section 401(a)(9) provide the details of these rules. There are separate rules for (1) individual retirement plans and defined contribution plans and (2) defined benefit plans. The requirements are applied separately to the employee or IRA owner's accrued benefit or account under each plan. However, in the case of IRAs and section 403(b) plans, there are rules allowing the minimum distributions required from each IRA or 403(b) plan of an individual to be taken out of any other IRA or 403(b) plan. For this purpose, traditional IRAs and non-Roth section 403(b) accounts are treated separately from Roth IRAs and section 403(b) plan designated Roth accounts.

Governmental plans

Section 823 of the Pension Protection Act of 2006 ("PPA") directs the Secretary of the Treasury to issue regulations under which a governmental plan[1012] (as defined in section 414(d) of the Code) will be treated as having complied with a reasonable good faith interpretation of the section 401(a)(9) required minimum distribution rules. Section 823 of PPA specifies that this rule is to apply to all years that the plan is subject to section 401(a)(9). This rule is currently reflected in the Treasury regulations and applies to qualified plans and section 403(b) plans that are governmental plans as well as governmental section 457(b) plans.

Defined contribution plans and IRAs

The regulations under section 401(a)(9) implement the rules for payment over life expectancy for defined contribution plans and IRAs by providing generally that 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.[1013] For distributions while the employee or IRA owner is alive, the distribution period is the number corresponding to the employee or IRA owner's age for the year from the uniform lifetime table included in the Treasury regulations.[1014] This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. 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. There are special rules in the case of annuity payments from an insurance contract.

[1012] Section 414(d) defines a governmental plan as a plan established and maintained for its employees by the government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing; any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669); and a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).

[1013] Treas. Reg. sec. 1.401(a)(9)-5.

[1014] Treas. Reg. sec. 1.401(a)(9)-9.

If an employee or IRA owner dies on or after the individual's required beginning date, the distribution period after death depends on whether there is an individual named as designated beneficiary for the account balance. If there is a designated beneficiary, the distribution period is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of the death.[1015] If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee or IRA owner's life, as of the year of death.[1016] In either case the life expectancy is reduced by one for each year that elapses after the year in which it is calculated.

If an employee or IRA owner dies before the individual's required beginning date, the required distributions after death also depend on whether there is a designated beneficiary. If there is no individual designated as beneficiary (for example the individual's estate is named as the beneficiary), the entire remaining interest must generally be distributed by the end of the fifth year following the individual's death. If there is a designated beneficiary, generally, distributions are required to be made using a distribution period measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual dies on or after the required beginning date.[1017] Special rules apply if the beneficiary of the employee or IRA owner is the individual's surviving spouse. In that case, distributions are not required to commence until the year in which the employee or IRA owner would have attained age 70½. Further, the distribution period is based on the spouse's life expectancy, recalculated each year.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. However, Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs. Under the regulations, in determining the required minimum distribution for each year after death, the owner of a Roth IRA is treated as having died before the required beginning date.[1018]

Defined benefit plans and annuity distributions

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity purchased from an insurance company. 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.[1019] If distributions are in the form of a joint and survivor annuity and the survivor

[1015] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[1016] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

[1017] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[1018] Treas. Reg. sec. 1.408A-6, A-14

[1019] Treas. Reg. sec. 1.401(a)(9)-6, A-14.

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 55 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

Description of Proposal

The proposal exempts an individual from the minimum distribution requirements if the aggregate value of the individual's account balances and accrued benefits under all IRAs and tax-favored retirement plans does not exceed $50,000 on a measurement date. However, benefits under qualified defined benefit pension plans that have already begun to be paid in life annuity form (including all forms of life annuity, such as joint and survivor, single, life and term certain) before the measurement date are excluded.[1020] In order to be entitled to the exemption, the taxpayer is required to complete a statement listing the taxpayer's aggregate retirement savings on the measurement date. The minimum distribution requirement would phase in ratably for individuals with aggregate retirement benefits between $50,000 and $60,000.

The initial measurement date for the dollar threshold is the first day of the calendar year in which the individual reaches age 70½ or, if earlier, the first day of the calendar year in which the individual dies, with additional measurement dates only at the beginning of the calendar year immediately following any calendar year in which the individual's IRAs or plans receive contributions, rollovers, or transfers of amounts that were not previously taken into account.

Effective date.−The proposal is effective for taxpayers attaining age 70½ on or after December 31, 2011.

Analysis

Essentially the Code provides a consumption tax for retirement savings accumulated in IRAs and employer-sponsored tax-qualified retirement plans. These tax-advantaged retirement savings plans modify the tax treatment of saving that would apply in a pure income tax, by permitting taxpayers to defer income tax on substantial amounts of current income. The deferral of income tax on income that is saved indirectly achieves substantially the same economic effects (that is, an exemption from tax on the normal return to saving) as a consumption tax. The existence of IRAs and other tax-advantaged forms of saving is thus a principal reason why the U.S. individual income tax system is described as a hybrid of an income tax and a consumption tax. However, this consumption tax model is primarily intended to encourage individuals to save a portion of compensation earned during their working lives for consumption by themselves and their spouses during retirement rather than providing a system for individuals and their spouses to preserve assets for their heirs after death.

[1020] There is no corresponding rule for annuity payments that have begun before the measurement date under an annuity contract purchased with funds from a defined contribution plan.

In recognition of the intention that tax-favored treatment of retirement savings is for retirement needs and not for beneficiaries, the Code imposes minimum distribution requirements that generally would result in funds in tax-deferred retirement accounts being largely distributed if the individual lived to his or her normal life expectancy. Specifically, the present law required minimum distributions are calculated using a joint life expectancy of the employee or IRA owner and an individual 10 years younger. This results in an annual required minimum distribution that rises as a percentage of the account gradually over the individual life after age 70, beginning at 3.56 percent of the account at age 70, rising gradually to 5.34 percent at age 80, to 8.78 percent at age 90, and 15.87 percent at age 100.

Advocates for the proposal argue that minimum distribution rules are not needed for individuals with only very modest retirement savings. Most of these individuals will likely have little choice but to consume their retirement saving during retirement unless they die prematurely. Advocates further argue that the proposal would provide simplification benefits at minimal revenue loss and without controverting the rationale for the provision of tax benefits for retirement saving. Some advocates argue that elimination of the required minimum distribution rule is desirable in order to preserve assets for potentially larger expenses later in life. However, it is important to recognize that individuals do not have to consume funds that are distributed from retirement accounts, but may continue to save them outside of the retirement account if they do not need to consume the funds when distributed.

The exemption may be available to some individuals who have more than modest retirement savings. For example, an individual may have a defined benefit plan under which annuity payments provide significant retirement income and still qualify for the exemption.[1021] Additionally, the proposal appears to apply separately for two members of a married couple. One member of the couple may have a high level of retirement savings even though the other member qualifies for the exemption. This may allow the couple to preserve the retirement savings of the member who qualifies for the exemption for the couple's heirs. The heirs are then permitted to delay commencement of distributions until they each attain age 70½, allowing the original $50,000 to accumulate tax free for many decades.

In order for the $50,000 limit to not create an arbitrary cliff between those exempt from the minimum distribution requirement and those subject to the required minimum distribution rules, the proposal includes a phase in of the minimum distribution requirements for taxpayers with retirement savings above $50,000 but not exceeding $60,000 on the measurement date. As discussed below in more detail, this phase in creates considerable complexity for taxpayers with retirement savings in this dollar range. This is not likely to be a sophisticated or well-advised group of taxpayers.

[1021] Some might argue that if there is an exemption for annuity payments under a defined benefit plan, there should be a corresponding exception for annuity payments under an annuity contract purchased with funds from a defined contribution plan. However, in that case, taxpayers could purchase an annuity contract with all retirement plan funds in excess of $50,000 and begin annuity payments before the measurement date.

Establishment of a record of aggregate account balances and accrued benefit on the measurement date

Some argue that this proposal would be difficult for taxpayers to understand, and for both taxpayers and IRS to keep the appropriate records to document eligibility for the exemption. Because eligibility for the minimum distribution exemption is based on a one-time snapshot of a taxpayer's level of retirement savings, there may be many taxpayers over age 70½ who do not qualify for the exemption but who, in any given year after the measurement year, have retirement savings below the level of many taxpayers who qualify for the exemption. This makes the record of the taxpayer's eligibility for the exemption, and the ability to keep that record, of critical importance.

The IRS will need to establish a system for individuals to claim the exemption either on their tax return, or through another election procedure, for the year that the individual attains age 70 ½ and document entitlement to the exemption. IRA trustees are already required to report end of year balances each year to IRA owners (or beneficiaries) and the IRS. A similar requirement will be needed for employer-sponsored tax-qualified retirement plans to provide a record for individuals and the IRS for the account balances and accrued benefits taken into account for purposes of the exemption. A methodology will be needed for determining the actuarial present value of an employee's accrued benefit under a defined benefit plan, and that amount also will need to be reported to the IRS and the employee. Some argue that documenting an individual's entitlement to the exemption is only possible if additional reporting requirements are imposed on employer-sponsored tax-qualified retirement plans. The Code does not currently require any reporting of annual account balances or the value of accrued benefits under employer-sponsored tax-qualified retirement plans other than IRAs.

Advocates respond that such reporting will not impose a significant additional burden because the Employee Retirement Income Security Act of 1974[1022] ("ERISA") currently requires individual benefit statements at least annually for defined contributions plans and every three years for defined benefit plans.[1023] Thus any incremental burden to provide an end of year statement for the year before the employee attains age 70½ is not likely to be significant. Others may respond that not all plans are covered by ERISA and defined benefit plans are not required to provide the accrued benefit as a single sum actuarial value.

Maintenance of a record of eligibility for the exemption

The present law required minimum distribution rules are designed so that, for nonannuity life-time distributions, an employee or IRA owner can determine the amount required to be distributed for the calendar year with two pieces of information, the account balance (generally determined as of the end of the prior calendar year) and the employee or IRA owner's age. If the employee or IRA owner's spouse is the designated beneficiary and more than 10 years younger than the employee or IRA owner, the age of the taxpayer's spouse is also relevant. With this

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[1022] Pub. L. No. 109-8 (2005).

[1023] ERISA sec. 105.

information and the life expectancy tables published in Treasury regulations that are reproduced in Publication 590 and other IRS forms and publications, the employee or IRA owner or anyone assisting that individual as well as plan administrators and IRA trustees can calculate the required minimum distribution. There is no need for the taxpayer or the IRS to keep a record of account balances, elections, or other actions taken in prior years.

A different approach had been taken in proposed regulations published in 1987 under which an employee's or IRA owner's election of designated beneficiary and recalculation of life expectancy as of the taxpayer's required beginning date determined the distribution period for the individual.[1024] Future elections could only shorten the period. This approach was apparently rejected by the IRS at least in part because requiring elections at age 70½ created complexities and recordkeeping burdens for employees and IRA owners. Maintenance and retrieval of records of elections made many years earlier can be particularly challenging for the elderly. Thus, it may be difficult for an elderly taxpayer to document entitlement to an exemption many years after the measurement year.

Advocates of the proposal respond that taxpayer records and elections from prior taxable years frequently affect the tax treatment of items in subsequent years. In the area of retirement savings specifically, record of basis recovery from prior distributions must be kept to determine the taxable portion of a subsequent year distribution.

Effect of continuing employment and contributions or accruals after age 70½

The administrability of the proposal may be further complicated by the fact that the contributions to a taxpayer's account may continue after the taxpayer attains age 70½. Although contributions to traditional IRAs are not permitted for the year a taxpayer attains age 70½ or later, contributions to a Roth IRA are permitted. Also, for taxpayers who continue to be employed or self employed, contributions to an employer sponsored plan may continue. Under the proposal, these amounts would be required to be added to the taxpayer's aggregate retirement savings on the measurement date. If the total with these additional aggregate contributions exceeds $50,000, then the taxpayer no longer qualifies for the exemption.[1025] Thus a running total of contributions after age 70 ½ would need to be maintained by the taxpayer, and presumably by the IRS as well. Even assuming that all taxpayers act in good faith and make their best effort to maintain these records, there is likely to be confusion as to who continues to qualify for the exemption.

Perhaps more important, to the extent that taxpayers are making the decision whether to make contributions (such as whether to make elective contributions under a section 401(k) plan), the exemption under the proposal may confuse unsophisticated taxpayers, making them less likely to make further contributions. These taxpayers may overvalue the exemption and be

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[1024] Prop. Treas. Reg. EE-113-82, 52 Fed. Reg. 28,070, (July 27, 1987).

[1025] It is not clear whether the loss of the exemption under the proposal for additional contributions is only prospective or requires correction for past years. If it is other than only prospective this would add considerable additional complexity to the proposal.

tempted to not further increase their retirement savings if they are at or near the $50,000 threshold. Minimum distributions generally are not required to commence to these taxpayers from the employer sponsored plan to which they are making contributions until after they actually retire from that employer.

Further, the proposal only exempts annuity benefits from the calculation if the annuity payments begin before the taxpayer attains age 70½. Most defined benefit plans do not allow annuity distributions to commence until after the employee retires.

Perception of fairness

As years elapse after the measurement date, there may be taxpayers who are the same age with equivalent levels of retirement savings, some of whom qualified for the exemption and others who did not. Further, at such later time, there are likely to be some taxpayers that do not qualify for the exemption but have lower retirement savings than taxpayers who are the same age and qualify for the exemption. If there are a significant number of such taxpayers with lower account balances, some argue that there is likely to be a perception that the minimum distribution requirement is not fair. This could erode confidence in the basic provision and lead to lack of compliance.

Application of de minimis rule to employer-sponsored tax-qualified retirement plans

Under present law, the minimum distribution requirement applies separately to each employer-sponsored tax-qualified retirement plan. The plan administrator for each plan does not need to take into account the amount of the employee's account balance under any other plan. Under this proposal, the exemption is determined based on the employee's aggregate account balances. The proposal does not change the basic rule that satisfying the minimum distributions requirement is a plan qualification requirement. Some argue that, absent the existence of a system for verifying an individual's eligibility for the exemption, a plan may require individuals claiming the exemption to cash out their qualified plan rather than risk the plan disqualification. Alternatively, IRS may allow plans to rely on reasonable representations by the employees that they qualify for the exemption, which may result in noncompliance with the minimum distribution rules.

Advocates of the proposal point out that employer-sponsored tax-qualified retirement plans are permitted to require distributions in accordance with the minimum distribution requirements even for individuals subject to the exemption, thereby avoiding any perceived complexity and disqualification risk.

Phase-out of the exemption

Under the proposal, there is a phase-out of the exemption for taxpayers with aggregate account balances on the measurement date between $50,000 and $60,000. This would require that these taxpayers calculate the required minimum distribution each year and then multiply the otherwise required amount by a fraction, the denominator of which is $10,000 and the numerator of which is the amount by which the taxpayers aggregate retirement savings exceeds $50,000. To the extent that the taxpayer works past retirement, and additional contributions are added to the

taxpayer's retirement savings, the numerator of this fraction would need to be adjusted to reflect the additional contributions.

Some argue that this phase-out adds a level of complexity that far exceeds its utility. However, without a phase-out of the exemption, a taxpayer with $50,001 would be subject to the minimum distribution requirement for life (and the beneficiaries after death) whereas the individual with only $50,000 is exempt from the requirement altogether. Some would argue that this cliff is not as significant as it would seem because taxpayers can resort to self help by taking withdrawals before the measurement date to bring the aggregate retirement savings below $50,000.

After-death distributions

The proposal's application to inherited accounts of beneficiaries of eligible taxpayers until the beneficiary attains age 70½ has the potential to allow a very long period of deferral depending on the age of the beneficiary. Further, these beneficiaries may have a high level of retirement savings. For example, a taxpayer may name the taxpayer's five year old grandchild as the designated beneficiary for the taxpayer's retirement savings. At a minimum a taxpayer's middle age children are likely to be named as designated beneficiaries and may have considerable retirement savings of their own.

Alternative approaches to de minimis rule

Some argue that a better approach would be to apply the required minimum distribution rules each year to an individual's account balance in excess of $50,000, or some other amount. Another similar alternative approach would be to waive the minimum distribution requirement for taxpayers with account balances below $50,000. Either alternative could be coupled with a significant decrease in deferral for survivor beneficiaries. An advantage of these alternatives is that records from prior years need not be taken into account in determining required minimum distributions for any year, and any two taxpayers with the same facts in a year are treated the same. However, these alternatives also present one of the same complications as the proposal. The minimum distribution requirement cannot be applied to each plan separately. Instead, sharing of information between plans and individuals would be required or the employee's representation would need to be accepted by the plan and the IRS. Instead of a one-time measurement of retirement saving, an annual aggregate measurement of total account balances and accrued benefits would be required and an annual determination of whether any amount is required to be distributed that year.

Advocates of a onetime permanent exemption point out that this approach does not permanently exempt a large segment of the retired population from the required minimum distribution rules. Further this approach does not allow for savings and investment growth for those close to the threshold without growing into being subject to required minimum distributions. Thus it is less likely that individuals will be permanently exempted unless the threshold is much higher than $50,000, in which case a different population benefits from the provision.

Prior Action

No prior action.

C. Allow 60-Day Rollover by Nonspouse Beneficiaries of Eligible Retirement Plans

Present Law

Tax free rollover of distributions from eligible employer plans

An eligible rollover distribution from an eligible employer plan[1026] may be rolled over tax free to another eligible retirement plan. A tax-free rollover may be accomplished either through a direct rollover or a 60-day rollover. A direct rollover is accomplished by direct payment through a trustee to trustee transfer from one eligible retirement plan to another. A 60-day rollover from an eligible employer plan is accomplished by contributing a distribution from an eligible employer plan within 60 days of the distribution to an eligible retirement plan. An eligible retirement plan means an individual retirement plan or an eligible employer plan.

An eligible rollover distribution is any distribution from an eligible employer plan with certain exceptions which include certain periodic payments, any distribution to the extent the distribution is a minimum required distribution, and any distribution made on account of hardship of the employee.[1027] Only an employee or a surviving spouse of an employee is allowed to roll over an eligible rollover distribution from an eligible employer plan to another eligible employer plan.[1028] In the case of an eligible rollover distribution from an eligible employer plan to a beneficiary who is not the surviving spouse of the employee whose benefit is being distributed ("nonspouse beneficiary"), a 60-day rollover is not permitted. The nonspouse beneficiary is only allowed to roll over the distribution tax free using a direct rollover. Further, the rollover must be to an individual retirement plan, not another eligible employer plan.[1029]

Direct rollover and 20-percent income tax withholding

An eligible employer plan is required to offer any distributee (employee, surviving spouse, or nonspouse beneficiary) of an eligible rollover distribution an opportunity to have the distribution paid as a direct rollover before making a direct payment of the eligible rollover distribution to the distributee. Further, before making the distribution, the plan administrator (or individual acting in that capacity for the plan) must provide the distributee with a notice

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[1026] An eligible employer plan is a qualified retirement plan, a section 403(b) plan, and a "governmental section 457(b) plan." A governmental section 457(b) plan is an eligible section 457(b) plan maintained by a governmental employer described in section 457(e)(1)(A).

[1027] Sec. 402(c)(4).

[1028] Section 402(c)(10) allows nonspouse beneficiaries to make a direct rollover to an IRA but not to another eligible employer plan.

[1029] If a trust is named as beneficiary and the beneficiaries of the trust meet the requirements to be designated beneficiaries, the trust can be treated as a nonspouse designated beneficiary, and the trustee is permitted to make a direct rollover to an IRA, provided that the IRA is established with the trust identified as the beneficiary. In such a case, the beneficiaries of the trust are treated as having been designated as beneficiaries of the decedent for purposes of determining the distribution period under section 401(a)(9), if the trust meets the requirements set forth in Treas. Reg. sec. 1.401(a)(9)-4, Q&A-5, with respect to the IRA.

explaining the distributee's choices between a direct rollover or 60-day rollover, and the tax consequences of not choosing to roll over the distribution. If, after receiving the notice, the distributee fails to elect a direct rollover of the distribution, the distribution is subject to mandatory 20-percent income tax withholding.

After-death minimum distribution requirement

A central element of the after-death minimum distribution requirement is whether an employee or IRA owner dies before, or on or after, the individual's required beginning date. For employer sponsored tax qualified plans (for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½), the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½, or retires.[1030] Under employer sponsored tax qualified retirement plans, for an employee who is a five percent owner in the year the employee attains age 70½, and for traditional IRAs, the required beginning date is April 1 following the calendar year in which the employee or IRA owner attains age 70½.

If an employee or IRA owner dies before the individual's required beginning date, the required distributions after death depend on whether there is a designated beneficiary. If there is no individual designated as beneficiary (for example the individual's estate is named as the beneficiary), the entire remaining interest must generally be distributed by the end of the fifth year following the individual's death. If there is a designated beneficiary, generally, distributions are required to be made using a distribution period measured by the designated beneficiary's life expectancy, based on the life expectancy table in the regulations, calculated in the year after the year of the death and reduced by one for each year thereafter.[1031] Special rules apply if the designated beneficiary is the surviving spouse.

If an employee or IRA owner dies on or after the individual's required beginning date, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If there is an individual who is the designated beneficiary of the individual, the regulations interpret this as allowing payments using a distribution period equal to the remaining years of the beneficiary's life expectancy, calculated in the same manner as applies if the individual died before the required beginning date. If there is no designated beneficiary, a distribution period equal to the remaining years of the employee or IRA owner's life, as of the year of death, based on the life expectancy table in the regulations.[1032]

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. However, Roth IRAs are subject to the after-death minimum distribution rules that apply to traditional IRAs.

[1030] Sec. 401(a)(9)(C).

[1031] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[1032] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

Required minimum distribution rules for rollover IRA of nonspouse beneficiary

Under section 402(c)(11), an IRA established to receive a direct rollover on behalf of a nonspouse designated beneficiary must be an inherited IRA. Thus, when a nonspouse beneficiary rolls over a distribution from an eligible employer plan to an IRA, the IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual and also identifies the deceased individual and the beneficiary, for example, "Tom Smith as beneficiary of John Smith."

The after-death minimum distribution requirements apply to the inherited IRA. The rules for determining the required minimum distributions under the distributing plan with respect to the nonspouse beneficiary also apply under the IRA. Thus, if the employee dies before his or her required beginning date and the five-year rule applies to the nonspouse designated beneficiary under the plan making the direct rollover (for example because the beneficiary inherits the IRA through the individual's estate), the five-year rule applies for purposes of determining required minimum distributions under the recipient's inherited IRA. If the life expectancy rule applies to the nonspouse designated beneficiary under the plan, the required minimum distribution under the IRA must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred. Similarly, if the employee dies on or after his or her required beginning date, the required minimum distribution under the IRA for any year after the year of death must be determined using the same distribution period as would have been used under the plan if the direct rollover had not occurred.

Tax free rollover of distributions from IRAs

A distribution from an IRA to an IRA owner or the surviving spouse of an IRA owner may be rolled over tax free to an eligible retirement plan. This can be accomplished by a 60-day rollover or a direct rollover. Distributions to nonspouse beneficiaries of an IRA are not permitted to be rolled over tax free. However, trustee-to-trustee transfers between IRAs are not treated as rollovers and are a permitted method to move funds from one IRA trustee to another by nonspouse beneficiaries. In contrast to 60-day rollovers or direct rollovers, trustee-to-trustee transfers between IRAs generally are implemented by contacting the transferee trustee and requesting that the transferee trustee arrange the transfer.

Roth conversions

If a distribution from an eligible employer plan that is not a designated Roth account or a traditional IRA is eligible to be rolled over tax free, it is permitted to be contributed to a Roth IRA if the amount of the distribution is included in gross income for the year of the distribution, thereby accomplishing a "Roth conversion."

Description of Proposal

The proposal allows 60-day rollovers for nonspouse beneficiaries under eligible retirement plans and IRAs. The recipient IRA is required to be established as an inherited IRA subject to the same after-death required distribution rule as applied to the distributing eligible retirement plan, as required under present law rules for direct rollovers by nonspouse

beneficiaries and for trustee-to-trustee transfers between IRAs. This provision allows Roth conversion of inherited IRAs.

Effective date.−The proposal is effective for distributions after December 31, 2011

Analysis

Advocates of this proposal point out that the present law limitation on 60-day rollovers for nonspouse beneficiaries present a trap for the unwary. They argue that nonspouse beneficiaries take distributions without realizing that a 60-day rollover is not available to nonspouse beneficiaries. The proposal alleviates this trap for the unwary under present law by permitting 60-day rollovers for nonspouse beneficiaries.

Critics of the proposal point out that allowing 60-day rollovers for nonspouse beneficiaries may create compliance issues for the IRS and cause different missteps by distributees. Under present law, 60-day rollovers by nonspouse beneficiaries are not allowed in order to ensure that the rollover IRA is set up as an inherited IRA subject to the after-death minimum distribution requirement that applied to the distributing plan. This prevents the nonspouse beneficiary from obtaining more deferral than allowed under the minimum distribution requirements by rolling over the distribution into an IRA that is not established as an inherited IRA. In the case of life-time distributions, an IRA is set up in the employee's or IRA owner's name and is automatically subject to the lifetime minimum distribution rules. However, in the case of a nonspouse beneficiary, the IRA must be titled in a specific manner to identify the IRA as an inherited IRA. In the case of a trustee-to-trustee transfer or direct rollover, the recipient trustee is generally put on notice that an inherited IRA with respect to the particular decedent must be established. It is possible that this obstacle could be overcome through reporting on the Form 5498 for the year in which the IRA is established and on the Form 1099R for the distribution, but this is unlikely to be as reliable a compliance tool as direct rollovers and trustee-to-trustee transfers.

Some have suggested that a correction mechanism for taxpayer mistakes such as allowing a recontribution to the original distributing plan to allow an opportunity for direct rollover may be a better approach than a specific rule allowing 60-day rollovers to IRAs by nonspouse beneficiaries. Advocates for allowing 60-day rollovers respond that many plans may not be willing to accept recontribution in order to correct a nonspouse beneficiary's failure to make a direct rollover. Plans are now required to offer a direct rollover to nonspouse beneficiaries. Plans may object to giving nonspouse beneficiaries who do not initially choose a direct rollover a second opportunity to make a direct rollover.

Some argue that, even if this proposal to allow 60-day rollovers by nonspouse beneficiaries is not adopted, the rule precluding nonspouse beneficiaries of an inherited IRA from being permitted to do a tax-free rollover to another IRA should be revised. Under present law, nonspouse beneficiaries of inherited IRAs are not permitted to convert a traditional inherited IRA to a Roth IRA. Allowing a rollover of an inherited IRA by direct rollover would make the rules for nonspouse rollovers from one IRA to another IRA consistent with the rules for a rollover from an eligible employer plan to an IRA.

Prior Action

No prior action.

D. Clarify Exception to Recapture of Unrecognized Gain on Sale of Stock to an ESOP

Present Law

Gain deferred on sale of certain employer securities to an ESOP or eligible employee worker-owned cooperative

In general

Under section 1042, a taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP)[1033] or to an eligible worker-owned cooperative[1034] to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period.[1035] To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP or eligible employee worker-owned cooperative; (2) the ESOP or eligible employee worker-owned cooperative must own, immediately after the sale, at least 30 percent of each class of outstanding stock, or the total value of all outstanding stock of the corporation issuing the qualified securities;[1036] (3) the ESOP or eligible employee worker-owned cooperative must preclude allocation of assets attributable to qualified securities to certain individuals;[1037] and (4) the taxpayer must provide certain information to the Secretary of the Treasury. To preclude the ESOP or eligible employee worker-owned cooperative from disposing of the qualified securities within three years of the date of the sale, an excise tax measured by dispositions or distributions which reduce the organization's interest in employer securities to less than 30 percent is imposed on the employer maintaining the ESOP or on the eligible worker-owned cooperative.[1038]

[1033] An employee stock ownership plan ("ESOP") is defined in section 4975 generally as a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer stock is held for the benefit of employees that meets certain additional requirements. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). Gain realized on the sale of employer securities to an ESOP may be taxed at capital gain rates.

[1034] An organization is an eligible worker-owned cooperative if (1) it is an organization described in section 1381, (2) a majority of the membership is comprised of employees of the organization, (3) a majority of its voting stock is owned by members, (4) a majority of its board of directors is elected by the members, each of whom have a single vote, and (5) a majority of the allocated earnings and losses of which are allocated to members on the basis of patronage, capital contributions, or some combination of patronage and capital contributions.

[1035] Qualified employer securities acquired by an underwriter in the ordinary course of the trade or business as an underwriter (whether or not guaranteed) are not eligible for this nonrecognition treatment.

[1036] Subsequent to the sale, the ESOP or eligible employee worker-owned cooperative generally must hold the qualified securities for at least three years. An excise tax applies for certain dispositions during that three- year period.

[1037] Sec.409(n)

[1038] Sec. 4948.

Qualified securities; qualified replacement property

For purposes of section 1042, qualified securities are defined as employer securities[1039] that (1) are issued by a domestic C corporation that, for at least one year before and immediately after the sale, has no readily tradable securities outstanding,[1040] (2) as of the time of the sale, have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property consists of any security issued by another domestic corporation, as defined in section 165(g)(2)), which does not, for the corporation's taxable year in which the securities are acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of section 1362(d)(3)(D)) exceeding 25 percent of the corporation's gross receipts for the taxable year preceding the taxable year of the purchase. In addition, securities of the domestic corporation that issued the employer securities qualifying under section 1042 (and of any corporation that is a member of a controlled group of corporations with such corporation) do not qualify as "qualified replacement property."

To be treated as qualified replacement property, such securities must be acquired within a replacement period beginning on the date three months prior to the date the qualified securities are sold and ending twelve months after the date of such sale. The basis of the taxpayer in qualified replacement property acquired during the replacement period is reduced by an amount not greater than the amount of gain realized on the sale which was not recognized pursuant to the election provided by this provision.

If more than one item of qualified replacement property is acquired, an allocation rule is provided to determine the taxpayer's basis in each item. Under the allocation rule, the basis of each item designated as qualified replacement property is reduced by an amount determined by multiplying the total gain eligible for nonrecognition treatment by a fraction. The numerator of the fraction is the cost of the item of replacement property and the denominator is the total cost of all such items.

Recapture of gain

If a taxpayer disposes of any qualified replacement property, notwithstanding any other provision of Code, gain (if any) must be recognized which was not recognized under section 1042(a) unless an exception applies. One of the exceptions is for a disposition by gift or by reason of the death of the individual making the section 1042(a) election.

[1039] Eligible securities must be employer securities within the meaning of section 409(1).

[1040] For the same period, the domestic corporation that issued the employer securities must not be a member of a controlled group of corporations that has readily tradable securities outstanding.

Transfers between spouses

Section 1041 generally provides that no gain or loss is recognized on a transfer of property between spouses, including former spouses but only if incident to divorce. Further, section 1041 provides that in the case of such a transfer, for purposes of the income tax subtitle of the Code, the property is treated as acquired by the transferee spouse (or former spouse) by gift and the basis of the transferee is the adjusted basis of the transferor. Transfer is incident to a divorce if the transfer occurs within one year after the date that the marriage ceases, or is related to the cessation of the marriage.

Description of Proposal

The proposal expands exceptions to the recapture rules of section 1042 for dispositions of qualified replacement property to provide an exception for transfers between spouses, including former spouses if incident to divorce, that are subject to the nonrecognition provision under section 1041. No inference as to present law is intended.

Effective date.−The proposal is effective for transfers made under section 1041 after December 31, 2011.

Analysis

Advocates of adding an exception to section 1042 for transfers under section 1041 argue that existing law is ambiguous because section 1041 does not expressly address the tax treatment of transferor for purposes of the income tax subtitle of the Code. Thus it is unclear whether a transfer described in section 1041 triggers the recapture provisions of section 1042. They argue that not providing an exception may either cause taxpayers to recognize gain that is not required or may be a trap for the unwary if recapture is required.

Advocates further argue that transfers between spouses, including former spouses incident to divorce, should not result in recognition of income under section 1042 for the same reasons that section 1041 was enacted, which is that Congress views a husband and wife as a single economic unit.[1041] This is also the reason why there is no gift tax for transfers between spouses. Transfers pursuant to divorce are a division of the marital property rather than a disposition of property. Thus, there is a stronger reason for nonrecognition than for disposition by gift or by reason of death.

Others respond that the exceptions to the recapture provisions for dispositions of replacement property should not be expanded. They argue that the nonrecognition provisions of section 1042 should be eliminated.

[1041] Joint Committee of Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), p. 710.

Prior Action

No prior action.

E. Repeal Nonqualified Preferred Stock (NQPS) Designation

Present Law

In general

Since 1997, the Code has required "nonqualified preferred stock" (NQPS) to be treated as if it were not stock for some purposes, but such treatment is not required for other purposes unless the Secretary of the Treasury so prescribes. In this connection, the Secretary of the Treasury has regulatory authority to prescribe the treatment of NQPS for any other purpose of the Code. The regulatory authority has never been exercised.

Gain or loss on transfers to controlled corporations

Under section 351 of the Code, a transfer of property to a corporation in exchange solely for stock of the transferee corporation is generally tax-free to each transferor, so that neither gain nor loss is recognized with respect to the transferred property, provided that immediately after the transfer the transferors, in the aggregate, own 80-percent control (as defined in section 368(c)) of the corporation.[1042]

If, in addition to stock, the transferor receives other property ("boot"), such as money, securities of the transferee corporation, or NQPS, then the transferor recognizes gain (but not loss) on the transfer (to the extent of the value of the other property).[1043]

The transferor recognizes gain or loss on a transfer of property, however, if the transfer fails to meet the requirements of the non-recognition rules altogether, for example, by failing the applicable 80-percent control requirement,[1044] or not receiving any stock in the exchange.

[1042] Control for this purpose means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. The IRS has ruled that "control" requires ownership of 80 percent of each class of stock that is not entitled to vote (Rev. Rul. 59-259, 1959-2 C.B. 115). Taxpayers may be able to construct stock that has a higher percentage of the vote than of value (or vice versa) and retain (or fail to retain) the amount each class necessary satisfy (or to fail to satisfy) this test in various circumstances.

The definition of control for this purpose is different from the definition for certain other purposes – for example, for purposes of allowing a tax-free liquidation of a subsidiary corporation into a parent (section 332), or for purposes of the rules treating certain transfers of stock between commonly controlled corporations as a contribution of the stock followed by a redemption distribution that is generally treated as a dividend (section 304).

[1043] Sec. 351(b). Since 1997, NQPS has not been treated as "stock" for this purpose. Sec. 351(g).

[1044] Certain prearranged dispositions of stock that would cause a failure of the control requirement may cause a transaction not to be within the scope of section 351, so that loss or gain on the transferred property is recognized. See, e.g., Rev. Rul. 54-96, 1954-1 C.B. 111 (prearranged plan caused loss of control); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (finding incorporator lacked requisite control under section 351 where, as part of the incorporation, he irrevocably contracted to sell 50 percent of the stock received).

Definition of nonqualified preferred stock

Preferred stock is generally "nonqualified preferred stock" if (i) the holder has the right to require the issuer or a related person to redeem or purchase the stock within the 20-year period beginning on the issue date of the stock, and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase, (ii) the issuer or a related person is required to redeem or purchase the stock within such 20-year period and such right or obligation is not subject to a contingency which as of the issue date makes remote the likelihood of redemption or repurchase, (iii) the issuer or a related person has the right to redeem or purchase the stock within such 20-year period and, as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[1045]

A right or obligation will not cause preferred stock to be NQPS, however, if (i) the stock relinquished or received is not in a corporation any of whose stock is, or is to become, publicly traded, and the right or obligation may be exercised only upon the death, disability, or mental incompetency of the holder, or (ii) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.[1046]

Preferred stock is defined as stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.[1047] In 2004, the statute was amended to add a statement that stock shall not be treated as so participating unless there is "a real and meaningful likelihood" of the shareholder actually participating in the earnings and growth of the corporation."[1048] In 2005, the statute was amended again, to provide that "If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends."[1049]

The legislative history states that "…in no event will a conversion privilege into stock of the issuer automatically be considered to constitute participation in corporate growth to any significant extent. The conferees also wish to clarify that stock that is convertible or exchangeable into stock of a corporation other than the issuer (including, for example, stock of a

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[1045] Sec. 351(g)(2)(A) and (B).

[1046] Sec. 351(g)(2)(C).

[1047] Sec. 351(g)(3)(A).

[1048] Pub. L. No. 108-357, sec. 899(a), amending section 351(g)(3).

[1049] Pub. L. No. 109-135, sec. 403(kk), amending section 351(g)(3).

parent corporation or other related corporation) is not considered to be stock that participates in corporate growth for purposes of the provision."[1050]

Other consequences of nonqualified preferred stock

In addition to the rules dealing with transfers to a controlled corporation, other corporate tax rules also permit certain reorganizations, divisions, and recapitalizations of corporations to be accomplished without tax to the exchanging shareholders or the corporations involved, provided that certain requirements are met and only to the extent that certain permitted property is received. Under these rules, NQPS that is exchanged or received with respect to stock other than NQPS is generally treated as non-permitted property (with an exception for certain recapitalizations of family owned corporations) so that gain (but not loss) is generally recognized on certain exchanges of stock in one corporation for NQPS in another, where the basic requirements of a qualifying transaction are otherwise met. However, except as provided in regulations that may be issued under Treasury regulatory authority, unlike the case of the section 351 transaction, the Code generally continues to treat nonqualified preferred stock as stock under the relevant rules for determining whether a transaction qualifies as a tax-free reorganization or division (apart from the rules for determining the extent of taxable "boot" consideration received in such a transaction).[1051]

For example, a transaction may generally qualify as a tax-free reorganization described in section 368(a)(1)(B) (a "B" reorganization) if one corporation acquires another corporation in exchange solely for voting stock of the acquiror. Any amount of other consideration will generally cause the transaction to fail qualification as a B reorganization. However, because NQPS is "stock" for purposes of section 368(a)(1)(B) (regarding qualification as a reorganization) but is treated as not stock for purposes of section 354 (regarding the treatment of shareholders in reorganizations) it is possible to have a valid B reorganization where shareholders recognize gain (but not loss) on receipt of voting NQPS that does not disqualify the reorganization but is treated as boot in their hands.

Treasury regulatory authority

Section 351(g)(4) provides that the Secretary of the Treasury may prescribe such regulations as may be necessary or appropriate to carry out the purposes of the rule adding NQPS to the category of property that is not permitted to be received within the nonrecognition provisions of section 351, and the corollary provisions of sections 354(a)(2)(C), 355(a)(3)(D)) and 356(e). The Secretary may also prescribe regulations, consistent with the treatment under section 351(g) and such other sections, for the treatment of NQPS under other provisions of the Code.

The legislative history states that "The Treasury Secretary has regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject this proposal in appropriate

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[1050] H.R. Rep. No. 105-220, p. 545 (1997) (conference report to accompany H.R. 2014).

[1051] Secs. 354(b)(2)(C), 355(a)(3)(D), and 356(e).

cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code."[1052]

Description of Proposal

The proposal repeals the NQPS provisions of the Code that treat NQPS as boot, and all other cross referencing provisions.

Effective date.−The proposal is effective for stock issued after December 31, 2011.

Analysis

Background of nonqualified preferred stock rules

The present law rules that treat NQPS as taxable consideration for some purposes were enacted in 1997. The legislative history states that the Congressional concern leading to the adoption of the rules was that "certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments."[1053] The legislative history includes the following examples as reasons for change.

> "As one example, a shareholder of a corporation that is to be acquired for cash may not wish to recognize gain on a sale of his or her stock at that time. Transactions are structured so that a new holding company is formed, to which the shareholder contributes common stock of the company to be acquired, and receives in exchange preferred stock. The acquiring corporation contributes cash to a holding company, which uses the cash to acquire the stock of the other shareholders. In the final acquisition structure, the shareholder who received the preferred stock may also have the additional benefit that the holding company, in which the shareholder now owns preferred stock, may itself own highly secure investments. (Similar results might also be obtained if the corporation to be acquired recapitalized by issuing the preferred stock in exchange for the common stock of the shareholder.) Features such as puts and calls may effectively determine the period within which total payment is to occur. In the case of an individual shareholder, the preferred stock may be puttable or redeemable only at death, in which case the shareholder obtains a basis step-up and never recognizes gain on the transaction."
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> Similarly, as another type of example, so called "auction rate" preferred stock has a mechanism to reset the dividend rate on preferred stock so that it tracks changes

[1052] H.R. Rep. No. 105-220, pp. 543-545 (1997).

[1053] H.R. Rep. No. 105-148, June 24, 1997, p. 472; S. Rep. No. 105-33, June 20, 1997, p. 150.

in interest rates over the term of the instrument, thus diminishing any risk that the "principal" amount of stock would change if interest rates changed."[1054]

If a shareholder in the examples described above had received "securities" in exchange for his stock, the shareholder would have recognized gain.[1055] Prior to the 1997 enactment of the NQPS rules, the shareholder would not recognize gain because he received "stock."

General discussion of Treasury reasons for change

In its General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals the Treasury explains as a reason for change that the hybrid nature of NQPS (that it is treated like debt for some purposes but stock for others) has made it a staple of affirmative corporate tax planning for the well advised, but a complexity increasing trap for the unwary. In particular, the explanation notes that NQPS often occurs in loss recognition planning, where NQPS is treated as debt-like boot, or to avoid the application of a provision that treats a related-party stock sale as a dividend.[1056]

Because the creation of NQPS does not require any immediate movement of cash or other property, it may be particularly attractive for use within a group of related parties to cause varying tax results.

In addition, taxpayers that desire to avoid NQPS treatment may add conditions to the stock that would cause it to fail the NQPS definition. For example, the stock might be redeemable after 21 rather than 20 years (still arguably a significant period), or the stock might be given a participation in corporate growth that would make the stock fail the requirement that it be "limited and preferred as to dividends and not participate in corporate growth to any significant extent."

[1054] *Ibid*. See also Martin D. Ginsburg and Jack S. Levin, Mergers, Acquisitions, and Buyouts (August 2010), Par. 902.1 et seq., giving an example of a similar transaction that could have been impacted by the 1997 legislation. That example is based on the facts of the acquisition of National Starch & Chemical Corp. detailed in *National Starch & Chemical Corp. v. Commissioner*, 93 T.C. 67 (1978) aff'd, 918 F.2d 426 (3rd Cir. 1990) which refers to a private letter ruling dated June 28, 1978 (described by Ginsburg and Levin as PLR 7839060 (June 28, 1978)). The IRS first concluded in PLR 7839060 that the described transaction was tax free to the shareholder who received the preferred stock (a private ruling may be relied upon only by the taxpayer receiving the ruling, though it may be indicative of IRS administrative practice). Later, the IRS issued revenue rulings taking the position that the transaction would not be respected as tax free to the shareholder because it was "an integral part" of a larger transaction that failed to meet the continuity requirements for a tax-free reorganization (Rev. Rul. 80-284, 1980-2 C.B. 117 and Rev. Rul. 80-285, 1980-2 C.B. 119). Later still, the IRS revoked those rulings and issued another, effective retroactively, concluding the transaction was in fact tax free to the shareholder (Rev. Rul. 84-71, 1984-1 C.B. 106).

[1055] In 1989, Congress changed the rule that previously had allowed securities (as well as stock) to be received without causing recognition of gain in a section 351 transaction, by removing securities from the permitted consideration. Pub. L. No. 101-239, sec. 7203(a).

[1056] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals,* February 2011, p. 88.

The Administration proposal views the repeal of NQPS as potentially the simplest way to eliminate one more source of electivity in the absence of other modifications to restrict such electivity.

In any case in which NQPS can be used for affirmative tax planning however, in determining the impact of repealing the provisions, consideration should be given to alternative structures taxpayers might use to accomplish similar results if the NQPS provisions were repealed.

In addition, some may be concerned that the elimination of the NQPS provisions would lead to resumption of the transactions at which those provisions were originally directed.

Possible alternatives that might be considered include (1) modifying the statutory application of the NQPS rules to make them more effective and limit the current uses that are considered troublesome, and (2) imposing other rules that could limit the potential for the transactions that are seen as troublesome whether or not the NQPS rules are repealed.

Examples of transactions that have caused current Treasury concern

In informal conversations with Treasury Department staff, a number of examples were provided illustrating the concern regarding the use of NQPS in affirmative tax planning. One such example is a case in which NQPS is used to increase the stock basis of member of a corporate group and to avoid the effect of section 304. In these transactions, the recipient of the NQPS may be nontaxable, so the effect of immediate gain recognition is unimportant while the resulting step up in basis is useful to the group.[1057] Additionally, if the NQPS is stock in foreign jurisdictions, its receipt may not be a taxable event for foreign purposes, a result that may not be achieved if other (non-stock) consideration is used.

Example 1: A foreign parent corporation (FP) with two wholly-owned U.S. subsidiaries (Sub 1 and Sub 2) seeks to increase the basis of the stock of Sub 1. FP contributes all the stock of Sub 1 to Sub 2, solely in exchange for NQPS of Sub 2. Because no stock other than NQPS is received in the transaction, the transaction fails to qualify as a valid section 351 transaction and is treated as a taxable sale of the stock. FP recognizes gain on the exchange but pays no U.S. tax because a foreign person is generally not taxed on U.S. capital gains. Section 304, which would deem the transaction to be a contribution of the stock of Sub 1 to Sub 2 in a section 351 transaction in exchange for stock of Sub 2 that is immediately redeemed by Sub 2 for the property, does not apply because for purposes of that section NQPS is still treated as "stock."[1058]

[1057] As one example, the high basis subsidiary stock of the U.S. subsidiary resulting from a NQPS transaction might be used in a later intragroup transfer that would satisfy the requirements of a D reorganization and allow the receipt of cash without dividend treatment. A separate proposal in the Administration's 2012 Budget Proposals would remove the present law limitation on the dividend treatment of cash to the amount of gain on the stock transfer. See discussion of the Administration proposal entitled "Repeal Gain Limitation for Dividends Received in Reorganization Exchanges," in Part V.E.6, *supra*.

[1058] Section 304 applies in the case of an acquisition "in return for property." Section 317 defines "property" for purposes of Part I (Distributions by Corporations) to mean "money, securities, and any other

As a result of the transaction, Sub 2 holds the stock of Sub 1 with a basis stepped up to fair market value.[1059]

With respect to this example, it is not clear why Treasury has not exercised its regulatory authority to treat NQPS as property for purposes of section 304. Furthermore, in considering the potential impact of the proposal on this type of case, consideration should be given to whether alternative means would remain available by which the foreign parent might still be able to structure a transaction with similar results.[1060]

Another example affirmative tax planning exploiting the hybrid nature of NQPS involves a related-party sale of stock to produce loss recognition.

Example 2: US parent (US P) has two wholly owned foreign subsidiaries, FSub 1 and FSub 2. US P holds the stock of FSub 1 with a built in loss. If FSub 1 liquidated into US P, the stock loss would not be recognized.[1061] To recognize the loss, US P sells 21 percent of FSub 1 stock to FSub 2, solely in exchange for NQPS of FSub 2. Again, neither section 351 nor section 304 applies, for the same reasons as in Example 1. The loss on sale of the 21 percent of the stock is deferred under section 267(f). FSub 1 then liquidates (e.g., by electing under the check-the-box rules be taxed as a partnership) triggering the stock loss on the retained 79 percent of the FSub 1 stock because no party holds 80 percent of the stock of FSub 1 under the definition required by section 332.

This example turns in part on respecting the sale treatment accorded to the transfer of ownership of FSub1 between US P and FSub 2,[1062] and also on the taxable liquidation treatment under section 331 of the Code once no corporation owns 80 percent of FSub 1.[1063] Again, it is not clear why the Treasury department has not exercised its authority to treat NQPS as property for purposes of section 304. Furthermore, in considering the potential impact of the proposal on

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property; except that such term does not include stock in the corporation making the distribution…" Section 351(g) does not affect the qualification of NQPS as "stock" under section 317 (absent regulations to the contrary).

[1059] Section 362 (the carryover basis rule) also does not apply because the transaction is not a valid section 351 or reorganization transaction.

[1060] As one possible example, a class of nonvoting preferred stock might be created that has relatively little value, and 21 percent of that class might be disposed of in a transaction that would cause the transaction to fail the requirements of 351 and also avoid section 304 because only stock is received. Some taxpayers may not wish to engage in transactions that break section 368(c) control. However, consideration should be given to whether a reacquisition of such control could be structured in the future if necesssary.

[1061] Sec. 332.

[1062] Sale treatment provides a deferred loss on the stock sold, that may be recognized when section 267(f) ceases to apply. See Treas. Reg. sec. 1.267(f)-1(a)(2) and Prop. Treas. Reg. sec. 1.267(f)-1 (REG-118761-08, April 20, 2011).

[1063] See, e.g., *Granite Trust v. United States*, 238 F.2d 670 (1st Cir. 1956).

this type of case, consideration should be given to alternative means that could remain available by which the US parent might still be able to structure a transaction with similar results.

A third example involves accelerating losses without gains.

Example 3: US parent corporation (P) has both loss and gain assets. It transfers the assets to a domestic subsidiary (S) in two steps, to recognize loss but not gain. First, the gain assets are contributed solely for common stock of S, in a transaction that satisfies section 351 so that no gain is recognized. Second, the loss assets are contributed to S solely in exchange for NQPS.

This example turns on the ability to separate the transfers and to cause the second transfer to fail the requirements of section 351. As in the prior examples, in considering the potential impact on this type of case if the NQPS provisions were repealed, consideration should be given to whether alternative means would remain available to structure a transaction with similar results, As in the prior examples, there are other means by which the parent might cause a transfer to fail the requirements for nonrecognition under section 351, possibly including receipt of a relatively low value class of nonvoting preferred of which 21 percent might be disposed of as part of the transaction.

A fourth example involves related party sales between controlled foreign corporations (CFCs).

Example 4: A US parent corporation (US P) has two wholly owned foreign subsidiaries, FSub 1 and FSub 2. FSub 2 has considerable earnings and profits. FSub 1 purchases business assets from FSub 2 for NQPS. The gain to FSub 2 from sales of active income assets is not subpart F income and is deferred. FSub 1 obtains the assets with a fair market value basis, which can be depreciated. The earnings and profits of FSub 2 remain with FSub 2. Because the transfer involved a transfer of assets for stock, the FSub 2 country might treat the transaction as a tax free transaction in which the basis of the assets carries over. At the same time it might be that the FSub1 country treats the NQPS issued by FSub 2 as debt, providing FSub 2 with an interest deduction.

If the NQPS rules were repealed, again, consideration should be given to other means taxpayers might use to accomplish similar results.[1064]

As another alternative, the Treasury department might consider whether this type of transaction potentially could be addressed at least in part under the covered asset acquisitions provisions of section 901(m) of the Code. That section enumerates certain transactions that are "covered asset acquisitions" and gives the Treasury Department authority to add additional

[1064] As one possibility, the taxpayer might use an instrument that is debt for U.S. tax purposes, though possibly this may not accomplish the full benefit of carryover basis to the acquiror Fsub 2. In the example, the maximum foreign benefit occurs if the NQPS is treated as stock by one country and as debt by another. As another possibility, the taxpayer might structure an assets for stock transfer that fails the requirements for a tax- free reorganization or for a section 351 transaction.

"similar" transactions. The basic purpose of that Code section to prevent heightened foreign tax credit benefits as a result of situations in which the U.S. treats a transaction as a sale of assets (resulting in stepped-up depreciable asset basis to the buyer and less foreign earnings for the buyer under U.S. concepts) while the buyer's foreign jurisdiction does not recognize that tax benefit and imposes tax on earnings that do not include the basis benefit (producing a greater proportionate amount of foreign tax associated with the amount of earnings and profits that measures the foreign tax credit for U.S. tax purposes). The result in the example resembles the result in the situations described in the Code, and thus potentially might be considered a similar transaction.

There are numerous other examples of tax planning using nonqualified preferred stock. Many of these turn on the continuing treatment of NQPS as "stock" for purposes of general Code rules such as sections 304 and 317, which apply dividend treatment, rather than sale or nonrecognition treatment, only when a shareholder receives property other than stock.[1065] Another example involves a statutory gap allowing a shareholder to recognize a loss on the exchange of stock for NQPS in certain types of reorganization transactions, without the statute requiring a corollary downward adjustment to the basis of property held by the corporation.[1066] Conceivably, some or all of these examples might have been addressed in Treasury regulations.

Possible alternative methods of dealing with the concerning transactions

As noted above, there may be a concern that if the NQPS provisions are repealed, taxpayers will resume the same use of NQPS as existed under pre-1997 law when it is to their advantage.[1067] However, it can be argued that the NQPS rules are sufficiently avoidable that it is not difficult for taxpayers to achieve results similar to those that the NQPS provisions were intended to limit, even under present law.

Even if the NQPS provisions were repealed, however, taxpayers may be able to achieve by other means results similar to those that may now be considered inappropriate uses of the NQPS provisions under present law.

[1065] See generally Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* (January 2011) at Par. 604.3. et. seq.

[1066] *Ibid*. at Par. 604.3.3, Examples 14 and 15; (noting that section 362(b) does not contemplate the allowance of loss recognition in a "B" reorganization, in which only stock must be received).

[1067] See, e.g., *On Tax, Obama Budget Tweaks Some Old Standards*, 2011 *Tax Notes Today* 31-1 (noting one practitioner that "sees the proposal as taxpayer favorable, as it presents an opportunity for people to transfer gain property to a corporation - without recognizing gain - and take back NQPS, which doesn't count as debt for financial accounting purposes").

Consideration could be given to possible alternative statutory approaches that may combat the transactions considered troublesome, whether the NQPS provisions are repealed or whether they are retained or strengthened.[1068]

If NQPS rules are retained, the statute might require treatment of NQPS as non-stock in more cases, rather than await Treasury regulations to achieve this result. As a variation on this approach, the statute might more narrowly limit the consequences of the NQPS rules to cases that do not involve transfers within a controlled group.

If it is thought that NQPS is debt-like and should be more consistently so treated, including within controlled groups, Congress might clarify the treatment of NQPS for purposes of the various dividend and related provisions of the Code, and for purposes of corollary basis adjustments to property that should follow when gain or loss has been recognized. Rules further limiting its use to provide favorable tax consequences might also be considered.[1069]

Furthermore, to the degree that the transactions considered troublesome could still be achieved by means other than the use of NQPS, consideration could be given to more broadly addressing the rules regarding such transactions.

As one example, consideration might be given to whether the liquidation of a subsidiary that would be a related party under section 267 had it not been liquidated should be allowed to trigger the recognition of any stock or other loss at the time of liquidation, or whether additional limitations on such recognition should be imposed.[1070]

[1068] In 2004 and in 2005, as a result of certain positions apparently taken by some taxpayers, Congress added the second and third sentences, respectively, of section 351(g), to reiterate the intent to prevent economically non-meaningful attempts to avoid the definition of NQPS. Pub. L. No. 108-357, sec. 899(a); Pub. L. No. 109-135, sec. 403(kk). If there are aspects of the present law provision that are insufficiently comprehensive, or that inappropriately allow taxpayers to take the position that stock is not NQPS, statutory modifications could be considered.

[1069] Congress has in some instances limited loss recognition but not gain recognition. See, e.g., section 362(e), requiring reduction of either inside asset basis or stock basis on certain contributions of loss property to a corporation; section 734(d) (requiring a reduction in the basis of partnership property in certain cases where a partner recognizes a loss on the partnership interest or property of the partnership receives an increased basis when distributed to a partner).

[1070] The Treasury Department has indicated that the liquidation should not trigger a loss from a prior intragroup sale of stock until parties (and their successors) are no longer in a controlled group relationship (see, e.g., Treas. Reg. sec. 1.267(f)-1(c); CCA 201025046; REG-118761-08, April 20, 2011), but there remains the question whether other built-in stock loss, on stock that has not been sold within the group, should be allowed to be recognized at the time of liquidation. A question might be raised whether section 267 or other provisions might be modified so that stock and asset losses would be deferred and perhaps coordinated to provide a single recognition event, for example, on later dispositions of the liquidated corporation's assets to unrelated parties.

F. Revise and Simplify the "Fractions Rule"

Present Law

Overview

The fractions rule is a component of the real property exception to the unrelated debt-financed income rules, which are themselves part of the unrelated business income tax ("UBIT") regime applicable to tax-exempt organizations. The fractions rule describes permissible partnership allocations of a leveraged real estate partnership with both taxable and tax-exempt partners. If the partnership allocations satisfy the fractions rule, then qualified tax-exempt investors (i.e., pension funds, schools, title trusts, and other "qualified organizations") are not subject to UBIT on income earned from the fractions-rule compliant partnership.

Partnership allocations

Partnerships generally

A partnership generally is not treated as a taxable entity for Federal income tax purposes (except for certain publicly traded partnerships), but rather, is treated as a passthrough entity.[1071] Income earned by a partnership, whether distributed or not, is taxed to the partners.[1072] Distributions from the partnership generally are tax-free.[1073]

Partnership allocations

The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement so long as the allocation has substantial economic effect, or otherwise must be allocated in accordance with the partners' interests in the partnership.[1074]

Partnership allocations generally are considered to have substantial economic effect if, as set forth in Treasury regulations, (1) partners' capital accounts are maintained in accordance with regulatory requirements, (2) partnership liquidating distributions are required to be made in accordance with partners' capital accounts, and (3) any deficits in capital accounts are required to be restored to the partnership.[1075]

[1071] Sec. 701.

[1072] Sec. 702.

[1073] Sec. 731. Rules are provided for determining the basis of distributed property in the hands of the distributee partner, as well as for determining adjustments to the distribute partner's basis in its partnership interest and the partnership's basis in its remaining assets. Secs. 732-734.

[1074] Sec. 704(b).

[1075] Sec. 704(b)(2) and Treas. Reg. sec. 1.704-1(b)(1) and 1.704-1(b)(2).

Unrelated business income tax

In general, an organization that otherwise is exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes.[1076] Tax-exempt organizations subject to the UBIT include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities.[1077]

Certain types of income are specifically exempt from the UBIT. These items include, among others, dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[1078] Organizations liable for tax on unrelated business taxable income ("UBTI") may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Special rules apply in the case of a tax-exempt organization that owns a partnership interest in a partnership that holds UBTI-producing property. A tax-exempt organization's share of partnership income that is derived from the property generally is taxed as UBTI unless an exception provides otherwise.[1079]

Debt-financed property

In general

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Special rules apply in the case of an exempt organization that owns an interest in a partnership (or a pass-through entity taxed as a partnership) that holds debt-financed property.[1080] In general, in such cases, if the partnership incurs acquisition indebtedness with respect to property that, if held directly by the exempt organization, would not qualify for an exception from the debt-financed property rules, the receipt of income by the exempt organization with respect to such property may result in recognition of unrelated debt-financed income.

Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization in acquiring or improving the property and indebtedness incurred either before or after acquisition or improvement that would not have been incurred but for the acquisition or

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[1076] Secs. 511-514.

[1077] Sec. 511(a)(2).

[1078] Sec. 512(b).

[1079] Sec. 512(c).

[1080] Sec. 512(c).

improvement of the property.[1081] Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption,[1082] (2) obligations to pay certain types of annuities,[1083] (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons,[1084] or (4) indebtedness incurred by a qualified organization to acquire or improve real property (the "real property exception").[1085]

Exception for debt-financed real property investments by qualified organizations

For purposes of the real property exception, a qualified organization is: (1) an educational organization described in section 170(b)(1)(A)(ii)[1086] and its affiliated supporting organizations; (2) a qualified trust described in section 401(a) (hereinafter "pension funds"); (3) a title holding company or trust described in section 501(c)(25) (insofar as its shareholders or beneficiaries are themselves organizations described in (1) or (2));[1087] or (4) a retirement income account described in section 403(b)(9).[1088] To qualify for the real property exception, an acquisition or improvement by the qualified organization must meet several requirements. These include: (1) a requirement generally that the price of the property is a fixed amount determined as of the date of the acquisition or completion of the improvement; (2) restrictions against payment of the indebtedness of the arrangement being dependent upon the revenue, income, or profits derived from the property; (3) restrictions concerning sale-leaseback arrangements; and (4) in general, a prohibition against seller financing.[1089]

Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. To qualify for the real property exception, the partnership must meet all of the above-described general requirements and must meet one of the following three requirements: (1) all of the partners of the partnership are qualified organizations; (2) each allocation to a partner of the partnership which

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[1081] Sec. 514(c)(1).

[1082] Sec. 514(c)(4).

[1083] Sec. 514(c)(5).

[1084] Sec. 514(c)(6).

[1085] Sec. 514(c)(9)(A).

[1086] This Code section generally describes an educational organization that operates as a school (i.e., "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").

[1087] Sec. 514(c)(9)(C)(iii) and 514(c)(9)(F).

[1088] Sec. 514(c)(9)(C).

[1089] Sec. 514(c)(9)(B)(i)-(v).

is a qualified organization is a qualified allocation (within the meaning of section 168(h)(6)); or (3) the partnership satisfies a rule prohibiting disproportionate allocations.[1090]

The fractions rule

The disproportionate allocation rule requires two things: first, that the organization satisfy what commonly is referred to as the fractions rule, and second, that each allocation with respect to the partnership have substantial economic effect within the meaning of section 704(b)(2).[1091] The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners.

Under the fractions rule, the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of overall partnership loss for the taxable year for which such partner's loss share will be the smallest.[1092] A partnership generally must satisfy the fractions rule both currently and for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization.[1093]

Background and history of the UBIT and debt-financed property rules

Business and debt-financed income prior to 1950

Until the introduction of the UBIT in 1950, exempt organizations enjoyed a full exemption from Federal income tax. There was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. Judicial decisions extended tax-exempt status to so-called "feeder" organizations that operated commercial businesses for the benefit of a charitable organization but which did not directly conduct any charitable programs themselves.[1094]

In addition to the use of feeder corporations as a source of revenue, another common practice of exempt organizations in the years before 1950 was the acquisition of real estate with borrowed funds. In a typical transaction, a tax-exempt organization would borrow the entire

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[1090] Sec. 514(c)(9)(B)(vi) & (E).

[1091] Sec. 514(c)(9)(E)(i).

[1092] Sec. 514(c)(9)(E)(i)(I).

[1093] Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

[1094] See, e.g., *C.F. Mueller Co. v. Commissioner,* 190 F.2d 120 (3d Cir. 1951) (upholding the exempt status of a corporation that acquired the C.F. Mueller pasta company on the ground that the pasta company's profits were destined for the New York University School of Law's exempt programs); *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938) (holding that a bathing beach business that turned its profits over to a charitable organization was exempt).

purchase price of real property, lease the property back to the seller under a long-term lease, and service the loan with tax-free rental income from the lease.[1095]

Revenue Act of 1950

As a response to these practices, Congress subjected charitable organizations (not including churches) and certain other exempt organizations to tax on their unrelated business income as part of the Revenue Act of 1950.[1096] The legislative history of the 1950 Act provides that "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition."[1097] Congress decided not to deny or revoke tax-exempt status solely because the organization carried on unrelated active business enterprises, but instead "merely [imposed] the same tax on income derived therefrom as is borne by their competitors."[1098] Congress excluded from the tax certain passive forms of income, concluding that such passive income was "not likely to result in serious competition for taxable businesses having similar income"[1099] and "should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations."[1100]

The 1950 Act also taxed as unrelated business income certain rents received in connection with the leveraged sale and leaseback of real estate.[1101] Here, Congress cited three objections to such transactions: (1) "the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption since the only contribution it makes to the sale and lease is its tax exemption"; (2) unchecked, such transactions could result in exempt organizations owning "the great bulk of the commercial and industrial real estate in the country . . . lower[ing] drastically the rental income included in the corporate and individual income tax bases"; and (3) the "possibility . . . that the exempt organization has in effect sold part of its exemption . . . by . . . paying a higher

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[1095] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[1096] Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the UBIT to the income of State colleges and universities. Sec. 511(a)(2)(B).

[1097] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). The Supreme Court has stated that the "undisputed purpose" of the UBIT is "to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed." *United States v. American Bar Endowment*, 477 U.S. 105, 114 (1986); *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986) ("Congress perceived a need to restrain the unfair competition fostered by the tax laws.").

[1098] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 39 (1950).

[1099] S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

[1100] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31 (1950).

[1101] There was an exception for rental income from a lease of five years or less.

price for the property or by charging lower rentals than a taxable business could charge."[1102] This provision was a precursor to the present-law tax on unrelated debt-financed income.

Tax Reform Act of 1969

In the Tax Reform Act of 1969, Congress extended the UBIT to all tax-exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities).[1103] In addition, the 1969 Act expanded the tax on debt-financed income beyond rents from debt-financed acquisitions of real property to encompass debt-financed income from interest, dividends, other rents, royalties, and certain gains and losses from any type of property. The reason for the expansion of the debt-financed income rules in 1969 is that the provision enacted in 1950 to tax income from certain leveraged sale-leaseback transactions involving real estate had proved ineffective, as taxpayers succeeded in structuring transactions that escaped the reach of the statute.[1104]

The Supreme Court considered one such transaction in the *Clay Brown* case.[1105] In *Clay Brown*, a charitable organization purchased a corporate business with little to no down payment and agreed to pay the balance of the purchase price to the corporation's former shareholders from the corporation's future profits. The charity liquidated the corporation and leased the business assets back to the sellers, who formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as deductible "rent" to the charity, which then paid most of these receipts back to the original owners as installment payments on the initial purchase price. The Supreme Court agreed with the taxpayer's characterization of the transaction as a sale. The original owners thereby succeeded in converting business income that would have been taxable at ordinary income rates to capital gains, while the exempt organization acquired the ownership of a business largely or wholly without investing any of its own funds. Thus, under the 1950 legislation, exempt organizations continued to be able to buy businesses and investments on credit, often at more than market price, without contributing much if anything to the transaction other than the benefit of their tax-exempt status.[1106]

Congress responded to cases such as *Clay Brown* and to reports of taxable parties converting ordinary income into capital gain through leveraged sale-leaseback transactions with

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[1102] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[1103] The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

[1104] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 62.

[1105] *Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965).

[1106] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 62.

tax-exempt organizations by enacting certain provisions of the 1969 Act.[1107] Specifically, Congress expanded the unrelated debt-financed income rules to cover not only certain rents from debt-financed acquisitions of real property, but also to cover debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property. The 1969 Act provided for certain limited exceptions to these rules, such as situations where the debt-financed property is related to the organization's exempt functions.

Enactment of the real property exception in 1980

In the Miscellaneous Revenue Act of 1980, Congress enacted an exception to the debt-financed income rules for certain real property investments by qualified pension trusts (the progenitor of the real property exception, described above). The exception does not apply, however, in any of five situations: (1) the acquisition price is not a fixed amount on the acquisition date; (2) the amount of indebtedness is dependent on the revenue, income, or profits derived from the debt-financed property; (3) the property is leased back to the seller (or a related party); (4) the property is acquired from or leased to a related person of the trust; and (5) the seller or person related to the trust provides nonrecourse financing, and the debt is subordinate to any other indebtedness on the property or the debt bore an interest rate significantly lower than that provided by unrelated parties.[1108]

Congress believed that such an exception was warranted because "the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose—the payment of employee benefits."[1109] Real estate investments are attractive "for diversification and to offset inflation. Debt financing is common in real estate investments."[1110] In addition, the exemption provided to pension trusts was appropriate because, unlike other exempt organizations, the assets of such trusts eventually would be "used to pay taxable benefits to individual recipients whereas the investment assets of other [exempt] organizations . . . are not likely to be used for the purpose of providing benefits taxable at individual rates."[1111] In other words, the exemption for qualified trusts generally results only in deferral of tax; unlike the exemption for other organizations. Congress also believed that the five limitations placed upon use of the exception would "eliminate the most egregious abuses addressed by the 1969 legislation."[1112]

[1107] S. Rep. No. 552, 91st Cong., 1st Sess. 62-63; H.R. Rep. No. 413, 91st Cong., 1st Sess. 44-46; Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 62.

[1108] See sec. 514(c)(9)(B)(i)-(v).

[1109] S. Rep. No. 96-1036, 96th Cong., 2d Sess. 29 (1980).

[1110] *Ibid*.

[1111] *Ibid*.

[1112] *Ibid*.

Predecessor to the fractions rule, 1984

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations, finding that "educational organizations generally were unable to avoid taxation on income from real property acquired for investment purposes because few institutions had sufficient assets to purchase property not subject to debt."[1113] At the same time, in the 1984 legislation Congress layered on additional conditions, including an absolute bar on seller financing.

The 1984 legislation also included an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property. The new restrictions were needed because prior law was "inadequate to prevent the shifting of tax benefits between tax-exempt organizations and taxable entities."[1114]

Under the 1984 restrictions on partnership allocations, the real estate exception to the debt-financed property rules applied only if either all of the partners of the partnership were tax-exempt organizations qualifying for the exception, or, if the partnership included other types of partners, such as taxable entities, then each allocation to a tax-exempt partner that was a qualified organization was a qualified allocation. Specifically, to meet the qualified allocation requirement, the qualified organization must be allocated the same percentage share of each item of partnership income, gain, loss, deduction, credit and basis, and its share must remain the same while it was a partner. Further, the allocation must have substantial economic effect under the partnership allocation rules of section 704(b).

The fractions rule, 1987

In 1987, Congress modified the restrictions on partnership allocations, adding the fractions rule.[1115] The new limitations on partnership allocations stemmed from a concern "that tax-exempt organizations are entering into transactions designed to transfer the benefit of their tax-exempt status to taxable organizations, through joint ventures involving debt-financed real property."[1116]

As described in the1987 legislative history, the provision requires that, in the case of a partnership including both tax-exempt and taxable partners, throughout the entire period that a tax-exempt organization is a partner, "(i) no distributive share of overall partnership loss allocable to a taxable partner can exceed such partner's smallest distributive share of overall

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[1113] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1151.

[1114] *Ibid*. In the Tax Reform Act of 1986, Congress provided exempt status for certain title holding companies (section 501(c)(25)) and at the same time extended the real property exception to such companies.

[1115] Sec. 514(c)(9)(B)(vi) & (E), enacted in sec. 10214 of The Revenue Act of 1987, Pub. L. No. 100-203.

[1116] H.R. Rep. No. 100-391, H.R. 3545, Report to accompany recommendations from the Committee on Ways and Means, House of Representatives, October 26, 1987, p. 1076.

partnership income for any taxable year, [and] (ii) no distributive share of overall partnership income allocable to a tax-exempt partner can exceed such partner's smallest distributive share of overall partnership loss for any taxable year...."[1117] In addition, each partnership allocation must have substantial economic effect under section 704(b).

In 1993, Congress relaxed some of the conditions required to meet the real property exception.[1118] In general, leasebacks to the seller (or a disqualified person) are allowed if no more than 25 percent of the leasable floor space in a building is leased back and the lease is on commercially reasonable terms.[1119] Seller financing is permitted if the financing is on commercially reasonable terms.[1120] In addition, the fixed price restriction and the requirement that indebtedness not be paid out of revenue, income, or profits of the acquired property are relaxed for certain sales by financial institutions.[1121]

Description of Proposal

The proposal replaces the fractions rule with a rule requiring that each partnership allocation have substantial economic effect (as required by current law) and that no allocation have a principal purpose of tax avoidance. The proposal provides regulatory authority to minimize the cliff effect of a technical violation of the rule.

Effective date.–The proposal is effective on the date of enactment.

Analysis

In general

The effect of the proposal is to liberalize the rules regulating leveraged real estate partnerships involving partners that are taxable and those that are tax-exempt pension funds, schools, title holding companies and other qualified organizations. By eliminating the fractions rule, the proposal permits leveraged real estate partnerships to allocate larger amounts of income or gain to tax-exempt partners and larger amounts of deductions, losses or credits to taxable partners than the amounts permitted under present law. As a result of the proposal, taxable partners investing in leveraged real estate partnerships would have less taxable income, and tax-exempt partners would have more tax-exempt income that is not subject to UBIT. The proposal, therefore, enables tax-exempt pension funds, schools, and other organizations to shift some of

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[1117] H.R. Rep. No. 100-495, Conference Report to accompany H.R. 3545, the Omnibus Buget Reconciliation Act of 1987, December 21, 1987, p. 954.

[1118] See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

[1119] Sec. 514(c)(9)(G)(i).

[1120] Sec. 514(c)(9)(G)(ii).

[1121] Sec. 514(c)(9)(H).

the benefit of their tax-exempt status to taxable partners by investing in leveraged real estate partnerships.

The unrelated debt-financed income rules

The proposal addresses an exception to the unrelated debt-financed income rules. The policy rationale for the unrelated debt-financed income rules themselves has been the subject of debate.

For example, some argue that that the unrelated debt-financed income rules were an overbroad reaction to a specific problem, and either should be repealed or substantially modified.[1122] It is argued that when Congress enacted the broader debt-financed income rules in 1969,[1123] Congress was reacting principally to the perceived abuse of a small number of sale-leaseback arrangements involving the sale of assets by taxable persons to tax-exempt organizations. The rules apply to situations beyond sale-leaseback arrangements, and thus the rules could be viewed as too broad in scope.

However, some point to legislative history explaining that Congress believed the debt-financed income rules were necessary to prevent tax-exempt organizations from trafficking in their tax-exempt status.[1124] Under this view, a significant function of the unrelated debt-financed income rules is to prevent the shifting of benefits of tax-exempt status from tax-exempt to taxable parties and other unintended tax consequences.[1125]

Nevertheless, it can be argued that the unrelated debt-financed income rules are uneven in application and permit economically similar transactions to be treated differently for tax purposes. For example, a tax-exempt organization may be able to replicate the economic consequences of acquisition indebtedness (which is generally taxable) through a derivative investment that is not taxable under the debt-financed income rules. As a result, some describe the debt-financed income rules as creating traps for the unwary and opportunities for the well-advised.[1126] However, development of financial products that permit the debt-financed income

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[1122] See, e.g., Suzanne Ross McDowell, "Taxation of Unrelated Debt-Financed Income," *The Exempt Organization Tax Review* (Vol. 34, No. 2) (November 2001), p. 210.

[1123] As discussed above, Congress expanded the unrelated debt-financed income rules in 1969 to tax both certain rents from debt-financed acquisitions in real property as well as debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property.

[1124] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[1125] See the 1982 Congressional testimony of the Treasury Department expressing this view: Statement of William McKee, Tax Legislative Counsel, Department of the Treasury, *1981-92 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 97th Cong., 2d Sess. 54 (1982).

[1126] See McDowell, *supra* n. 1122, p. 212 (arguing that well advised organizations oftentimes can structure leveraged investments that are not treated as debt-financed under the unrelated debt-financed income rules, but which have similar economic consequences to investments that, if made, would be treated as debt-financed).

rules to be circumvented arguably should not, by itself, motivate repeal of the rules, but rather, could motivate updating of the rules to take account of developments since their enactment. The evolution of means of circumventing the rules does not, alone, create a need for a change in their underlying policy.

The real property exception to the unrelated debt-financed income rules

The real property exception permits investments in leveraged real estate by specified types of tax-exempt organizations to remain outside the application of UBIT which otherwise would apply to debt-financed income from the investment. Some have argued that while the real property exception to the unrelated debt-financed income rules is appropriate for pension funds, the exception should not have been extended to tax-exempt schools.[1127] The exception for unrelated debt-financed investments in real estate by pension funds may be justified because the exception results only in deferral of income recognition. That is, the pension fund's income generally is taxed to individuals upon receipt of distributions from the pension fund. The exception for such investments by tax-exempt schools, however, results in a permanent exemption from income because the schools do not subsequently distribute the income in a taxable transaction. Thus, this income escapes Federal income tax permanently, causing economic distortions with respect to real estate investment.

Others point to the availability of the real estate exception for tax-exempt schools but not for other section 501(c)(3) organizations such as charities or churches. The availability of the exception for some, but not all, tax-exempt investors in leveraged real estate can be criticized as piecemeal repeal of the unrelated debt-financed income rules favoring some organizations over others.[1128]

Critics of the proposal may argue that expanding the exception for more tax-exempt organizations' investments in real estate could encourage organizations to seek exceptions for investments in other types of property, undermining the larger policy of the rules.[1129] The concern is that if tax-exempt schools can invest in leveraged real estate, while tax-exempt charities or churches are denied the same advantage, then by analogy, this tax advantage could

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[1127] When the real estate exception first was enacted for qualified pension trusts in 1980, the Treasury Department did not oppose its enactment. Consistent with Congress' rationale for limiting the real property exception to pension funds, the Treasury Department testified that an exception limited to pension funds could be justified, because exempting investment income was a primary reason for such funds' exemption from income tax. See statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury, *Five Miscellaneous Tax Bills: Hearings on S. 650 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 96th Cong., 2d Sess. 298 (1980).

[1128] See statement of William McKee, Tax Legislative Counsel, Department of the Treasury, *1981-92 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 97th Cong., 2d Sess. 54-55 (1982).

[1129] This concern was raised in Treasury Department before Congress in 1983, relating to the statement of Robert G. Woodward, Acting Tax Legislative Counsel, Department of the Treasury, *Hearings before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 98th Cong., 1st Sess. 88-89 (1983).

easily be expanded to additional types of organizations or to leveraged investments in other kinds of property without regard to any overarching policy. Critics of the proposal may assert that, bit by bit, continued expansions of the exception would vitiate the function of the debt-financed rules to prevent shifting of the benefit of tax-exempt status to taxable investors in the case of joint investments in the specified type of property.

Further, critics may argue that the proposal's expansion of the currently narrow exception to the unrelated debt-financed income rules exacerbates the disparity among organizations that can benefit from the real estate exception and those that cannot. As discussed, the exception currently benefits only a few tax-exempt organizations (i.e., pension funds, tax-exempt schools, and other qualified organizations), and only with respect to leveraged real estate investments. The effect is to distort the economic incentives for investment in leveraged real estate transactions. Under the proposal, taxable investors who invest with certain tax-exempt investors not only can receive any present-law tax benefits designed to encourage real estate investment generally, but also can share in the tax benefit of their coinvestors' tax-exempt status. Arguably, the latter result is not consistent with Congressional intent in permitting tax-exempt status for specified organizations that engage in identified activities. In addition, critics may argue that the proposal does not address the broader policy concerns raised by the unrelated debt-financed income rules themselves.

The complexity of the fractions rule

Many have argued that the mechanics of the real property exception, in particular the fractions rule, are overly complex and impose unfair burdens on pension funds, schools and other qualified organizations—and their taxable partners—seeking to take advantage of the exception.[1130] Such critics view the fractions rule as a burdensome requirement that prevents taxable and qualified tax-exempt organizations from entering into commercially reasonable transactions. They maintain that the provision is mechanically and conceptually flawed, a significant impediment to common, non-abusive transactions, and, in many respects, simply unworkable. Some argue, for example, that the requirement that the fractions rule be satisfied hypothetically on a prospective basis for future years of a partnership creates hardships in structuring what ordinarily would be routine real estate investment transactions.

Others, however, argue that while compliance with the fractions rule is complex, the fractions rule does not prevent most commercially reasonable transactions because such

[1130] See William H. Weigel, "Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)," 50 *Tax Lawyer* 3 (1996-1997), pp. 632-635; see generally Arthur A. Feder & Joel Scharfstein, "Leveraged Investment in Real Property through Partnerships by Tax Exempt Organizations after the Revenue Act of 1987 — A Lesson in How the Legislative Process Should Not Work," 42 *Tax Lawyer* 55 (Fall 1988). The New York State Bar Association Tax Section has issued numerous reports calling for the modification of section 514(c)(9)(E), including the following: "Report on Section 514: Debt-Financed Income Subject to UBIT (August 12, 2010); Report on Simplification of the Internal Revenue Code" (March 18, 2002); "Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations" (February 14, 1997); "Report on Notice 90-41 and Certain Other Issues Arising Under Section 514(c)(9) of the Internal Revenue Code Relating to Debt Financed Real Estate Investment by Tax Exempt Organizations" (May 27, 1991).

transactions can be structured to meet one of the other real property exceptions to the unrelated debt financed income rules. These other exceptions, among other things, permit a UBIT exception for income from a partnership in which all partners are qualified organizations rather than a mixture taxable and tax-exempt partners, or if all the partnership allocations are qualified allocations within the meaning of section 168(h)(6). Furthermore, defenders of the fractions rule argue that the transactions that the fractions rule inhibits are those that may be suspect from a tax policy standpoint because such transactions involve shifting of taxable income to tax-exempt partners and tax benefits, such as deductions and losses, to taxable partners.

Operation of the proposal

The proposal does not explicitly eliminate the fractions rule, but rather, substitutes a test that depends on whether partnership allocations between taxable and tax-exempt partners have a principal purpose of tax avoidance. Thus, the proposal substitutes a purpose-based test that requires a factual inquiry into taxpayers' state of mind in place of the present-law test that is relatively mechanical, depends on the terms of the partnership agreement, and is generally self-executing.

The efficiency of tax administration arguably is compromised by removing an objective and self-executing tax rule and substituting a subjective test that involves a factual inquiry that has difficulties of proof. Ascertaining the taxpayers' purpose depends on the taxpayer's own assertions and on circumstantial evidence such as documentation of a business purpose that the taxpayers themselves control. A subjective test reduces the clarity and predictability of the tax law. The proposal can be criticized as adding needless enforcement difficulties to the tax law and as requiring disproportionate use of IRS resources to administer and taxpayer resources to apply. Moreover, critics may argue that the proposal may decrease taxpayer certainty because it can be difficult to conclude that any partnership allocation has substantial economic effect. Although substantial economic effect is already a requirement under present law, removing the more mechanical aspect of the present-law fractions rule may increase the relative importance of the substantial economic effect test and highlight any potential for flexibility or uncertainty in it.

The proposal could further be criticized as effectively repealing any limitation on allocations between taxable and tax-exempt partners in leveraged real estate partnerships, both as a matter of administrability of the tax law and as a matter of tax policy. If the purpose test is difficult to enforce, the proposal may permit a more significant change in taxpayer behavior than is intended. Critics may assert that if the intent of the proposal is to repeal the fractions rule, then it should repeal the rule explicitly rather than leaving in place an inefficient test that is costly and difficult to enforce. They may also criticize the purpose test because it is not self-executing as is the present-law mechanical test, but rather, requires interpretation in each situation. Further, if the intent is to repeal the fractions rule, then larger policy considerations should be addressed, such as the function of the debt-financed income rules to prevent shifting of taxable income and losses between taxable and tax-exempt owners of leveraged real estate.

On the other hand, if the intent of the proposal is not to fully repeal the fractions rule, but rather, to make it less burdensome for taxpayers, then consideration could be given to developing a simpler test that is nevertheless self-executing and mechanical in operation, permitting clarity and predictability in the tax law. For example, if a problem with the current operation of the rule

arises when capital contribution obligations of taxable and tax-exempt partners are not drawn down proportionately, or perhaps concurrently, then that situation should be addressed specifically rather than broadly eliminating all the rules and substituting a vague purpose-based test. Similarly, if some assert that the purpose of the fractions rule might be circumvented through the use of participating debt of the partnership, then specific rules should be developed to address the use of participating debt.

Taxpayers have pointed out that the fractions rule may cause difficulties in the case of particular situations potentially resulting in disparate allocations to taxable partners and to tax-exempt partners. Even so, the same taxpayers may be concerned that a vague, purpose-based test could be at least as difficult to apply to specific transactions. Without rules determining which forms of transaction are acceptable under the tax law, uncertainty could prove more of an impediment to commercially reasonable transactions than does present law. On the other hand, a purpose test would ultimately be interpreted in regulatory and judicial guidance, so that the rule could become clearer with time.

The continued relevance of the fractions rule

In addition to the argument that the fractions rule is complex, critics of the present-law rule argue that the tax law has evolved since the fractions rule was enacted in 1987[1131] (and has changed even more since the predecessor to the fractions rule was enacted in 1984), and that other provisions in the Code now preclude loss and income shifting transactions of the sort Congress designed the fractions rule to prevent. Under this view, the fractions rule no longer serves an important function.

Advocates of the proposal argue that recently enacted tax legislation alleviates the need for a strict formulaic fractions rule because such rules limit the ability of taxable investors in real estate partnerships to use the tax benefits generated by those partnerships.[1132] For example, such legislation includes the recent codification of the economic substance rules and rules requiring taxpayer reporting of tax shelter and similar transactions, as well as the lengthening of the depreciation period for commercial real estate, enactment of the passive activity loss rules and at-risk rules, and strengthening of the alternative minimum tax. However, very few of these rules actually postdate the fractions rule, as the passive loss rules, alternative minimum tax, and somewhat longer depreciation periods[1133] were enacted in 1986, prior to the fractions rule, and the at-risk rules were enacted in their initial form in 1976 (though they were expanded in 1984 and modified in 1986). Thus, arguably, other provisions of the tax law have not supplanted the fractions rule.

[1131] Sec. 10214 of The Revenue Act of 1987, Pub. L. No. 100-203.

[1132] Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals*, p. 89 (February 2011).

[1133] The recovery periods of some asset classes were subsequently further lengthened.

In addition to rules affecting the ability of taxable investors to use disproportionate allocations in a leveraged real estate partnership to benefit from the tax-exempt status of qualified organizations, recent rules directed at curbing abusive transactions arguably also help to prevent such transactions. The economic substance doctrine prevents purely tax-motivated income and loss shifting transactions that do not change a taxpayer's economic position in a meaningful way.[1134] In addition, income and loss shifting transactions could or might be reportable transactions which participating taxpayers and their advisors must disclose to the IRS.[1135] Moreover, tax-exempt organizations participating in prohibited tax shelter transactions are now subject to excise taxes and disclosure requirements.[1136]

On the other hand, taxpayers are still motivated to engage in income and loss shifting transactions between taxable and tax-exempt partners, although not necessarily in the form addressed by those present-law rules designed to limit them. The fractions rule arguably is still necessary to prevent shifting of the benefit of tax-exempt status to taxable partners in those leveraged real estate partnership transactions that cannot be structured to meet one of the other exceptions to the unrelated debt financed income rules. Some conclude that the fractions rule, therefore, continues to function as intended. Elimination of the fractions rule increases the availability of income and loss shifting transactions involving leveraged real property of partnerships between taxable and tax-exempt organizations that cannot fall within another exception to the unrelated debt financed income rules.

Prior Action

No prior action.

[1134] See sec. 7701(o).

[1135] See secs. 6011, 6111, and 6112.

[1136] See sec. 4965.

G. Repeal Preferential Dividend Rule for Publicly Traded Real Estate Investment Trusts (REITs)

Present Law

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually as a dividend;[1137] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[1138]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[1139]

Preferential dividend rule

A "preferential dividend" does not qualify for the REIT dividend deduction, and cannot count toward the requirement that a REIT distribute 90 percent of certain REIT income as a dividend. A dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference.[1140]

A similar rule had applied to regulated investment companies ("RICs"), which are entities that must invest primarily in stocks and securities and are subject to Federal income tax under a regime similar to that for REITs regarding deductible dividends. In 2010, the

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[1137] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, additional distribution requirements must be met in order to avoid an excise tax under section 4981.

[1138] Secs. 856 and 857.

[1139] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[1140] Sec. 562(c) and secs. 857(a)(1), 857(b)(2)(B), and 561.

preferential dividend rule was repealed for publicly offered RICs (defined as RICs that are either (1) continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended), (2) regularly traded on an established securities market, or (3) held by or for no fewer than 500 persons at all times during the taxable year.[1141]

RICs are generally required to be subject to the Investment Company Act of 1940[1142]; though REITs are not always so subject.[1143]

Character of certain dividends of RICs and REITs

A dividend of a REIT or RIC is ordinary income to the recipient shareholder but is not a qualified dividend for purposes of the special 15-percent maximum individual dividend rate under section 1(h)(11),[1144] except to the extent the dividend is identified as qualified and is attributable to income that was taxed to the REIT or RIC at regular corporate rates because not previously distributed, or is attributable to qualified dividends received by the REIT or RIC from other corporations and identified as such by the REIT or RIC to its shareholders.[1145]

In addition to the ability of a REIT or RIC to identify certain dividends or portions thereof as dividends that are qualified dividends for individuals, a REIT or RIC may also identify a dividend or a portion thereof as a capital gain dividend to the extent of the entity's net capital gain.[1146] A RIC (but not a REIT) may also identify certain short-term capital gain dividends and certain interest-related dividends as dividends that retain the identified character. The special identifed character of these dividends does not affect domestic shareholders or certain foreign shareholders that are otherwise subject to U.S. tax. [1147]

RICs and REITs may have more than one class of stock and the classes of stock may carry different rights and preferences. However, in 1989 the IRS ruled that if a RIC has two or more classes of stock and designates the dividends it pays on one class as consisting of more

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[1141] Sec. 562(c) and sec. 67(c)(2)(B). The Secretary of the Treasury may decrease the 500 person minimum shareholder requirement in the case of RICs that experience a loss of shareholders through net redemptions of their shares. Sec. 67(c)(2)(B)(ii).

[1142] Sec. 851(a)(1)(A). An exception applies if the RIC qualifies for and has elected under the Investment Company Act of 1940 the special treatment available to a business development company. Sec. 851(a)(1)(B).

[1143] Many REITs may not be subject to the Investment Company Act of 1940, for example, due to exclusions for certain real estate investments, to differences in the manner in which attribution rules apply to determine number of shareholders. See *infra*, notes 1153, 1154 and 1155.

[1144] This preferential rate is scheduled to expire for taxable years after 2012.

[1145] Sec. 1(h)(11)(D)(iii) and sec. 857(c). In the case of a RIC (but not a REIT) certain dividends may similarly be designated as eligible for the corporate dividends received deduction under section 243. Sec. 854.

[1146] Sec. 852(b)(3) and sec. 857(b)(3).

[1147] Secs. 871(k) and 881(e).

than that class' proportionate share of a particular type of income, the designations are not effective for Federal income tax purposes.[1148] A 1997 IRS notice that deals with RIC and REIT capital gains designations describes temporary regulations intended to be issued under section 1(h) to provide guidance regarding the application of varying capital gains rates on different types of capital gain to capital gains dividends of RICs and REITs. The notice reiterates that the principles of the 1989 ruling regarding proportionate dividends apply to both REITs and RICs.[1149]

Explanation of Proposal

The proposal repeals the preferential dividend rule for publicly traded REITs. The Treasury Department is given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

Effective date.−The proposal applies to distributions that are made (without regard to section 858)[1150] in taxable years beginning after the date of enactment.

Analysis

The proposal notes that the original tax purpose of the preferential dividend rule was to prevent tax avoidance by closely held personal holding companies. For example, the proposal notes that in 1936 there was concern that a closely held corporation's shareholders might collude to agree that distributions might be made in a manner not provided in the stock instruments so as to vary the receipt of income by shareholders in different tax brackets in a manner beneficial to the shareholders.[1151]

It is understood that many instances of REITs violating the rule may involve inadvertent "foot-faults" in timing of dividends (e.g. an error in the REIT's shareholder records that causes a dividend to be paid to a shareholder after it was paid to other shareholders in that class). It is understood that in many such cases, except for the consequences of the preferential dividend rule, the "foot-fault" may cause little or no change in tax consequences, and no change in the

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[1148] Rev. Rul. 89-81, 1989-1 C.B. 226.

In the case of a RIC that has different classes of income that may be designated as such to shareholders, the IRS has ruled that the RIC may designate the maximum amount permitted under each of the provisions allowing designation as a particular type of income, even if the aggregate amount so designated exceeds the total amount of dividend distributions, and that shareholders preferring different designations may select the maximum amount permitted under the designation of that type. Rev. Rul. 2005-31, 2005-1 C.B. 1084.

[1149] No temporary regulations have been issued.

[1150] Section 858 permits a REIT to treat certain dividends paid after the close of a taxable year as if they had been paid during the taxable year.

[1151] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, p. 91.

amount of payment made to particular shareholders. However, once a preferential dividend has been paid, it may be impossible to correct the "foot-fault" without making a corrective dividend that also is "preferential" in that it does not follow the exact terms of the stock involved. Thus, "foot-faults" with little or no tax consequence technically jeopardize the tax qualification of a REIT. It is understood that the IRS has entered into closing agreements with taxpayers on a case by case basis, that permit the REIT to retain its tax qualification, though they may require other adjustments or payments by the REIT. If an inadvertent past "foot-fault" is discovered in the course of due diligence for a merger or a stock offering by the REIT, the ability to complete the transaction may be delayed while a closing agreement is pursued, so that the auditors can represent to the purchaser or other new investors that the REIT or RIC will be qualified as such.

In describing the proposal, the Treasury Department notes that the RIC modernization Act of 2010 repealed the preferential dividend rule as applied to publicly traded RICs, and states that as applied to publicly traded REITs, the preferential dividend rule has also ceased to serve a necessary function, because corporate and securities laws prevent preferences and ensure fair treatment.

It should be noted, however, that REITs are not necessarily subject to the same securities law rules forbidding certain preferences that apply to RICs. In particular, when the preferential dividend rule was repealed for publicly traded RICs in 2010, a technical explanation noted that RICs are by definition[1152] subject to the Investment Company Act of 1940 (the "40 Act"), which itself contains rules regarding shareholder fairness, including rules regarding appropriate allocations of expenses to shareholders. Many REITs may not be subject to the Investment Company Act of 1940,[1153] for example, due to exclusions for certain real estate investments[1154] or to differences in the manner in which attribution rules apply to determine number of shareholders.[1155]

The Treasury Department's description of the proposal does not explicitly state the intended definition of "publicly traded" to which the exception would apply. The comparable RIC rules that were enacted in the RIC modernization Act of 2010 cover two types of RICs: (1)

[1152] Sec. 851(a)(1)(A). An exception applies if the RIC qualifies for and has elected under the Investment Company Act of 1940 the special treatment available to a business development company. Sec. 851(a)(1)(B). See Joint Committee on Taxation, *Technical Explanation of H.R. 4337, the "Regulated Investment Company Modernization Act of 2010," for Consideration on the Floor of the House of Representatives*, (JCX 49-10), September 28, 2010.

[1153] Section 856 does not require REITs to register under the 40 Act.

[1154] See, e.g., 15 U.S.C. sec. 80a-3(c)(5)(C) (excluding from the definition of "investment company" any person who is not engaged in the business of issuing redeemable securities, face amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate).

[1155] The 40 Act generally excludes from the definition of "investment company" entities with 100 or fewer beneficial owners. Although a REIT must have at least 100 beneficial owners (sec. 856(a)(5)), the relevant definitions of an "owner" are not identical. Accordingly, it may be possible to structure a REIT that satisfies the Code's 100-shareholder requirement but qualifies for the 40 Act exclusion.

those the stock of which is "regularly traded on an established securities market" and (2) those with no fewer than 500 shareholders.[1156]

In general, although REITs may not be subject to the 40 Act, REITs that are regularly traded on an established securities market or that have 500 shareholders (and at least $10 million of assets) would be subject to registration and reporting requirements under the Securities and Exchange Act of 1934.[1157]

One the one hand, it could be argued that the existence of a certain number of shareholders, or of SEC registration and reporting requirements, does not of itself necessarily prevent the possibility that shareholders might collude to stream dividends in a manner most favorable to shareholders' particular and differing tax treatments.[1158]

However, the proposal provides a partial backstop against the potential to shift the tax effects of dividends to different shareholders in a manner most favorable to the shareholders, by making explicit the Treasury authority to preclude any tax effect to disproportionate allocations of different types of dividends to different shareholders.

The proposal also grants the Secretary of the Treasury explicit authority to provide cures to avoid treatment of the dividend as disqualified, in those cases in which the preferential dividend rule still applies. Thus, in cases where the rule is violated, the Secretary of the Treasury could formulate rules more broadly applicable than the current closing agreement practices.[1159]

Prior Action

No prior action.

[1156] Sec. 67(c)(2)(B)(i)(II) and (III). Section 67(c)(2)(B)(i)(I), dealing with continuous offerings, is not relevant to REITs, nor is the reference to the Treasury Secretary's discretion to permit fewer than 500 shareholders in cases involving RIC redemptions of shareholders.

[1157] 15 U.S.C. sec. 78l(g) and 17 C.F.R. sec. 240.12(g)-1.

[1158] Some have argued that the securities "fairness" considerations policed by the Investment Company Act of 1940 (or by any other Federal securities law) should not be the concern of the tax rules on preferential dividends, but that the tax rules should be concerned with the tax effect of any preferential distributions. See, e.g., New York State Bar Association Tax Section, "Report on the Application of Code Section 562(c) to Regulated Investment Companies and Real Estate Investment Trusts" (Report 1153) (April 7, 2008).

[1159] Nothing in the proposal is intended to preclude the IRS from continuing to follow a case by case closing agreement practice where appropriate.

H. Reform Excise Tax Based on Investment Income of Private Foundations

Present Law

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[1160] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[1161] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the UBIT that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code. Exempt operating foundations are exempt from the section 4940 tax.[1162]

Nonoperating private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[1163]

[1160] Sec. 4942(g).

[1161] Sec. 4940(e).

[1162] Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

[1163] Sec. 4942(d)(2).

Description of Proposal

The proposal replaces the two rates of excise tax on private foundations with a single rate of tax of 1.35 percent. Thus, under the proposal, a tax-exempt private foundation generally is subject to an excise tax of 1.35 percent on its net investment income. A taxable private foundation is subject to an excise tax equal to the excess (if any) of the sum of the 1.35-percent net investment income excise tax and the amount of the UBIT (both calculated as if the foundation were tax-exempt), over the income tax imposed on the foundation. The proposal repeals the special reduced excise tax rate for private foundations that exceed their historical level of qualifying distributions.

Effective date.–The proposal is effective for taxable years beginning after the date of enactment.

Analysis

The proposal has the effect of increasing the required minimum charitable payout for private foundations that pay the excise tax under present law at the two-percent rate.[1164] This may result in increased charitable distributions for private foundations that pay only the minimum in charitable distributions under present law. For example, if a foundation is subject to the two-percent excise tax on net investment income, the foundation reduces the amount of required charitable distributions by the amount of excise tax paid. Because the proposal decreases the amount of excise tax paid on net investment income for such foundations from two percent to 1.35 percent, the proposal increases such foundations' required minimum amount of charitable distributions by an amount equal to 0.65 percent of the foundation's net investment income. Thus, the proposal results in an increase of charitable distributions in the case of foundations paying the two-percent rate and distributing no greater than the required minimum under present law.

Foundations paying the two-percent rate that exceed the required minimum under present law generally would not have to increase their charitable distributions as a result of the proposal. Although the required minimum amount of charitable distributions would increase as described above, foundations making distributions in excess of the minimum would not have to increase charitable distributions as a result of the proposal (except to the extent that the increase in the required minimum amount was greater than the excess of a private foundation's charitable distributions over the required minimum amount of present law). However, a reduction in the excise tax rate may result in increased charitable distributions to the extent that a foundation decides to pay out the amount that otherwise would be paid in tax for charitable purposes.

The proposal also eliminates the present-law two-tier tax structure. Some have suggested that the two-tier excise tax is an incentive for foundations to increase the amounts they distribute

[1164] Operating foundations are not subject to the same minimum charitable payout rules as private non-operating foundations. Sec. 4942(a)(1). Their payout requirements do not take into account taxes imposed on net investment income. See sec. 4942(i)(3).

to charities.[1165] Critics of the present-law two-tier excise tax have criticized the efficiency of the excise tax as an incentive to increase payout rates. First, critics note, the reduction in excise tax depends only upon an increase in the foundation's rate of distributions to charities, not on the size of the increase in the rate of distributions. Thus, a large increase in distributions is rewarded by the same reduction in excise tax rate as is a small increase in distributions. There is no extra incentive to make a substantial increase in distributions rather than a quite modest increase in distributions.

For foundations that current pay the excise tax at the one-percent rate, the proposal arguably would have the opposite effect, i.e., it would reduce the amount of charitable distributions by reducing the required minimum charitable payout.[1166] Therefore, to the extent it is considered a desirable policy goal to encourage more grant making by private foundations, the proposal may have only mixed success, encouraging additional charitable distributions by some foundations, while discouraging additional charitable distributions by others.

In addition, critics assert that, under a number of circumstances, the present-law two-tier excise tax can create a disincentive for foundations to increase charitable distributions substantially.[1167] In order to take advantage of the present-law one-percent excise tax rate, a private foundation must increase its rate of charitable distributions in the current year above the average of the rates in the preceding five years. Whether the present-law two-tier excise tax structure creates an incentive or disincentive to increase payout rates depends, in part, on whether the foundation currently is subject to the one-percent tax rate or the two-percent tax rate. Because modest increases in payout rates qualify a foundation for the one-percent tax rate, some analysts suggest that a foundation may be able to manage its distributions actively so that the foundation qualifies for the one-percent tax rate without substantially increasing its payout rate.[1168] For a foundation subject to the one-percent rate in the current year, an increased payout in any year becomes part of the computation to determine eligibility for the one-percent rate in future years. Because increased payouts in one year make it more difficult for the foundation to qualify for the one-percent rate for five subsequent years, it increases the possibility that the foundation will become subject to the two-percent tax rate in each of the five years following the

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[1165] In general, foundations that make only the minimum amount of charitable distributions and seek to minimize total payouts have no incentive to decrease their rate of excise tax because such a decrease would result in an increase in the required minimum amount of charitable distributions, thus making no difference to the total payout of the private foundation.

[1166] The foundation would pay 0.35 percent more in excise tax, which would reduce the foundation's required minimum charitable distribution.

[1167] See C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," 12 *American Journal of Tax Policy*, pp. 399-447 (Fall 1995).

[1168] For example, if over a 10-year period the foundation increased its payout rate from the minimum 5.00 percent to 5.01 percent, to 5.02 percent, up to 5.10 percent, the foundation generally would qualify for the one-percent excise tax rate throughout the 10-year period.

temporary increase in distributions. Consequently, over time, the one-percent rate provides a disincentive for increasing charitable distributions.

On the other hand, for a foundation currently subject to the one-percent excise tax rate and also making charitable distributions at a rate above the minimum required amount, the present-law two-tier excise tax can create a disincentive for foundations to reduce their payout rate. A reduction in the foundation's payout rate one year would reduce distributions below its five-year moving average, thereby increasing the likelihood the foundation's net investment income is taxed at the two-percent rate, rather than the one-percent rate, for the year it decreases distributions.[1169]

For a foundation currently subject to the excise tax at the two-percent rate, an increase in its payout rate may qualify the foundation for the one-percent excise tax rate. If the increase does qualify the foundation for the one-percent rate, and the foundation maintains the same payout rate for the subsequent four years, the foundation generally will be eligible for the one-percent tax rate in each of the five years. Hence the reduced tax rate can create an incentive to increase payout rates. However, even in the case of a two-percent excise tax paying foundation, the present-law two-tier excise tax can create a disincentive for a foundation to increase charitable distributions substantially in any one year compared to a strategy of slowly increasing payouts over several years. For example, consider a foundation that has had a payout rate of five percent for several years. Suppose the foundation is considering increasing its payout rate. Consider two possible strategies: increase the payout rate to eight percent in the current year followed by rates of 5.5 percent thereafter; or gradually increase the payout rate by increments of one-tenth of one percent annually for five years. While a substantial increase in any one year may qualify the foundation for the one-percent tax rate for that year, subsequent year payout rates of 5.5 percent would fail to qualify the foundation for the one-percent tax rate.[1170] Thus, under the first option, the foundation would pay the one-percent tax rate for one year and be a two-percent tax rate payor subsequently. Under the second option, the foundation would qualify for the one-percent rate in each year. However, total payouts are greater under the first option.

In summary, the incentive effects of the present-law two-tier excise tax depend upon the situation in which the foundation finds itself in the current year. In 2006, 44.4 percent of foundations were one-percent tax rate payors and 55.6 percent were two-percent rate payors. Among large foundations (assets of $50 million or greater) 48.4 percent were one-percent rate payors and 51.6 percent were two-percent rate payors.[1171] A number of analysts suggest the

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[1169] Whether a reduction in payout rate causes the foundation to pay the two-percent tax rate depends upon the specific pattern of its payout rate in the preceding five years and the magnitude of the decrease in the current year.

[1170] In this example, after having paid out 8.0 percent, the five-year average payout for the first year in which the foundation pays out 5.5 percent would be 5.6 percent.

[1171] See Figure F in Cynthia Belmonte, "Domestic Private Foundations and Charitable Trusts: Tax Years 2005 and 2006," Internal Revenue Service, *Statistics of Income Bulletin*, 29, Fall 2009, p. 270.

optimal tax strategy for a private foundation under present law is to choose a target rate of disbursement, maintain that rate in all years, and never fall below the target in any year.[1172]

Critics of the present-law excise tax structure observe that the median payout rate of large nonoperating private foundations (foundations with total assets of $50 million or more) was 5.1 or 5.0 percent in each year from 1991 through 1995 and was 5.0 percent in 1999, arguably demonstrating that the two-tier structure encourages foundations to limit distributions.[1173] However, the payout rate for such foundations increased to 5.5 percent in 2001[1174] before falling back to 5.1 percent in 2004, 4.8 percent in 2005, and 5.2 percent in 2006.[1175] The median payout rates for foundations with assets between $10 million and $50 million declined annually from 5.4 percent in 1990 to 5.1 percent in 1995 and 1999[1176] but increased slightly to 5.4 percent in 2003, 5.2 percent in 2004, 5.4 percent in 2005, and 5.7 percent in 2006.[1177] Smaller foundations' payout rates appear to fluctuate more widely from year to year. The median payout rates for foundations with assets between $100,000 and $1 million, for example, declined from 6.7 percent in 1990 to 5.5 percent in 1995 and 5.4 percent in 1999,[1178] but increased to 6.2 percent in

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[1172] Steuerle and Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," p. 438.

[1173] See Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999, p. 73 and Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002, p. 148.

[1174] See Figure J in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 2001," Internal Revenue Service, *Statistics of Income Bulletin*, 24, Fall 2004, p. 153.

[1175] See Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts: Charitable Distributions and Investment Assets, Tax Year 2004," Internal Revenue Service, *Statistics of Income Bulletin*, 27, Fall 2007 p. 186; Figure I in Cynthia Belmonte, "Domestic Private Foundations and Charitable Trusts: Tax Years 2005 and 2006," Internal Revenue Service, Statistics of Income Bulletin, 29, Fall 2009, p. 274.

[1176] See Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 p. 73 and Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002, p. 148.

[1177] See Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts: Charitable Distributions and Investment Assets, Tax Year 2004," Internal Revenue Service, *Statistics of Income Bulletin*, 27, Fall 2007, p. 186; Figure I in Cynthia Belmonte, "Domestic Private Foundations and Charitable Trusts: Tax Years 2005 and 2006," Internal Revenue Service, Statistics of Income Bulletin, 29, Fall 2009, p. 274.

[1178] See Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 p. 73 and Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002, p. 148.

2001.[1179] The median payout rates for foundations with assets less than $1 million were 5.7 percent in 2005 and 7.0 percent in 2006.[1180]

Finally, some argue that the tax on net investment income of private foundations serves no legitimate policy purpose and thus should be eliminated rather than modified and retained. The tax originally was intended as a fee to fund administration of exempt organizations generally. However, there is no evidence that revenue from the tax affects in any way the amount that is appropriated to the IRS for administration of programs related to exempt organizations. Thus, the original reason for the tax is not present and, arguably, the tax could be eliminated.[1181]

Prior Action

The President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals included a proposal to replace the two-tier excise tax rate structure with a single excise tax rate of one percent.

[1179] See Figure J in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 2001," Internal Revenue Service, *Statistics of Income Bulletin*, 24, Fall 2004, p. 153.

[1180] See Figure I in Cynthia Belmonte, "Domestic Private Foundations and Charitable Trusts: Tax Years 2005 and 2006," Internal Revenue Service, *Statistics of Income Bulletin*, 29, Fall 2009, p. 274.

[1181] The staff of the Joint Committee on Taxation recommended elimination of the tax in 2001 on the ground that elimination would simplify the tax law and could be justified because the original reason for the tax no longer existed. See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Volume II, p. 459.

I. Simplify Tax-Exempt Bonds

1. Simplify rules relating to arbitrage investment restrictions

Present Law

Interest on debt obligations issued by State and local governments for governmental purposes generally is excludable from gross income. Two types of arbitrage investment restrictions apply to investments of tax-exempt bond proceeds pending use for governmental purposes. The purpose of the arbitrage restrictions is to limit arbitrage incentives for issuing tax-exempt bonds too early, issuing bonds in excessive amounts, or allowing such bonds to remain outstanding longer than reasonably necessary to accomplish the governmental purposes of the bonds. These restrictions limit investment returns that exceed the yield or effective interest rate on the tax-exempt bonds. One type of restriction, called "yield restriction," limits investment returns in the first instance, and a second type called "arbitrage rebate," require issuers to repay arbitrage investment earnings to the Federal government at prescribed intervals. These restrictions developed in different ways over a long period of time, beginning with yield restriction in 1969 and continuing with the extension of the rebate requirement to all tax-exempt bonds in 1986. Various exceptions apply in different ways to these two types of arbitrage restrictions, including exceptions for prompt expenditures of bond proceeds, reasonable debt service reserve funds, small-issuers, and other situations.

Yield restriction

To prevent the issuance of Federally subsidized tax-exempt bonds that do not directly support governmental projects or specified activities, the tax exemption for State and local bonds does not apply to any arbitrage bond. An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments ("yield restrictions"). In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal government ("arbitrage rebate").

Arbitrage rebate

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or

replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Present law includes certain exceptions to the arbitrage rebate requirements. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.

Second, in the case of bonds to finance certain construction activities, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied. Issuers qualifying for this "construction bond" exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.[1182] This item is discussed in more detail below in "small-issuer exception.

Small-issuer exception

An exception to arbitrage rebate is provided for bond proceeds from a bond issue if: (1) the issue is issued by a governmental unit with general taxing powers; (2) the issue is not a private activity bond; (3) 95 percent or more of the net proceeds of the issue are to be used for local governmental activities of the issuer (or of a governmental unit of the jurisdiction which is entirely within the jurisdiction of the issuer); and (4) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such governmental unit during the calendar year in which the issue is issued is not reasonably expected to exceed $5 million.

Description of Proposal

The proposal has three elements described below.

Unify yield restriction and rebate further

The proposal unifies yield restriction and rebate further except for investments of escrow amounts from advance refunding bonds under section 149(d) or as otherwise provided in Treasury regulations. The proposal relies on arbitrage rebate as the principal type of arbitrage restriction on tax-exempt bonds.

[1182] Subject to the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16) as modified by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312).

Modify arbitrage rebate rules to provide a broad three-year exception

The proposal creates a new three-year spending exception to arbitrage rebate for tax-exempt bonds which satisfy the following requirements: (1) the bonds are either tax-exempt governmental bonds or tax-exempt private activity bonds (including 501(c)(3) bonds); (2) the bonds are not advance refunding bonds under 149(e) nor may the proceeds of such bonds be used for "restricted working capital expenditures" as defined in regulations; (3) the bonds are fixed rate (not variable rate) and have a weighted average maturity of at least five years; (4) the issuer is required to spend at least 95 percent of the bond proceeds within three years of the date of issuance (there are no interim spending requirements); and (5) the issuer is required to proceed with due diligence to spend the bond proceeds.

Small-issuer exception

The proposal eliminates the requirement that the issuer be a governmental unit with general taxing powers. Also, the proposal increases the five million dollar limit to $10 million dollars and indexes it for inflation in the future.

Effective Date

The proposal is effective for bonds issued after the date of enactment.

Analysis

Unify yield restriction and rebate further

Proponents may argue the added complexity of the yield restriction requirement is unnecessary to prevent tax arbitrage by issuers except in circumstances involving large dollar amounts of bond proceeds invested over relatively long periods of time. They maintain that retaining the yield restriction rules for advance refunding bonds is a response to that concern. Further, they assert that the arbitrage rebate rules operate to ensure the goals of discouraging early and over-issuance of tax-exempt bonds in most cases so the proposal to repeal the yield restriction rule in most instances serves to eliminate unnecessary and complex rules. Opponents of the proposal may disagree that arbitrage rebate rules are duplicative of the yield restriction requirement in all cases other than advance refunding bonds. Further, while both sets of rules may require application in complex fact patterns the development and widespread use of computer programs by issuers have eased tax compliance concerns over that time.

Modify arbitrage rebate rules to provide a broad three-year exception

The proposal seems to be based on the belief that in most instances the interest rate on short-term taxable bonds is too low relative to interest rates on long-term tax-exempt bonds to provide significant arbitrage opportunities. Following that theory, the arbitrage rebate rules can be significantly simplified thereby affording many issuers relief from the compliance complexity of the present-law arbitrage rebate rules without concern for early or over-issuance of tax-exempt bonds. Opponents of the proposal may be skeptical of the proponents' belief that arbitrage opportunities are constricted by the yield curve. Advocates of the present-law system may be concerned that the proposed broad exception to the arbitrage rebate rules without any interim

spending requirements during the three-year period of this new exception represents a departure from the present-law scheme and is inconsistent with tax policy in this area over the past several years. If, as proponents seem to believe, market interest rates (e.g., short-term vs. long-term) already operate to assuage any concerns about early and over-issuance of tax-exempt debt, opponents of the proposal may question why the Administration retains the limits on rebate contained in the proposal or any limits at all.

Small-issuer exception

Increasing the five million dollar limit to $10 million and indexing the new $10 million limit for future inflation is based on the theory that the value of five million dollar limit to issuers has been eroded by inflation and that it should be updated to take into account inflation both since its enactment and any future inflation. In addition, increasing the size of the small-issuer exception would reduce compliance burdens for a large number of small issuers, while affecting a relatively small dollar amount of bond dollar volume.

Expanding the present-law small-issuer exception to governmental issuers without general taxing powers could be based on a recognition that many traditional government issuers lack traditional taxing powers (e.g., utility districts that depend on revenue assessments). These issuers also may find it difficult to access the capital markets in any other way. Opponents of this element of the proposal may view the present-law general taxing powers requirement as a way to ensure that issuers of tax-exempt debt have the ability through taxes collected to repay their debt. Opponents also may have a concern that expanding the exception may encourage State and local governments to restructure themselves to expand the number of bond issuers that can qualify under the new small-issuer rule.

Prior Action

No prior action.

2. Simplify qualified mortgage bond targeting requirements

Present Law

In general

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds that are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") (secs. 103(b)(1) and 141).

Qualified mortgage bonds

Generally

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including purchase price limitations for the home financed with bond proceeds and income limitations for homebuyers. In general, the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 90 percent of the average area purchase price (i.e., the average single-family residence purchase price purchased for the most recent one-year period in the statistical area in which the residence is located) (sec. 143(e)). Also, the income limitation for buyers generally is met if all the owner-financing provided under the issue is provided to individuals who have family income of 115 percent or less of the applicable median family income (sec. 143(f)).

In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or replace existing mortgages.

First-time homebuyers

In addition to the purchase price and income limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement) (sec. 143(d)). The first-time homebuyer requirement does not apply to targeted area residences (described below).

Special rules for targeted area residences

A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress (sec. 143(j)).

In addition to the waiver of the first-time homebuyer rule, targeted area residences have special purchase price limitations and income limitations. For targeted area residences, the purchase price limitation is applied by substituting 110 percent for 90 percent (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence) (sec. 143(e)(5)). For targeted area residences, the income limitation generally is met if at least two-thirds of all the owner-financing provided under the issue is provided to individuals who have family income of 140 percent or less of the applicable median family income. The other third is not subject to an income limitation (sec. 143(f)(3)).

Description of Proposal

The proposal repeals the purchase price and refinancing limitations for qualified mortgage bonds.

Effective Date

The proposal is effective for bonds issued after the date of enactment.

Analysis

Proponents of the repeal of the purchase price limitation argue that the purchase price limit is unnecessary and adds complexity. Proponents argue that the present-law income limitation provides sufficient targeting of the subsidy and that the mortgagor income limit typically is a more constraining factor than the purchase price limit. Opponents discount the complexity argument and say that the subsidy is properly targeted to ensure that tax dollars are not used to subsidize the purchase of relatively more expensive housing.

Proponents contend that lower-and moderate-income homeowners need a tax-subsidized vehicle for refinancing their mortgages. Opponents contend that the subsidy is properly targeted to the purchase of housing by first-time low-and moderate income homebuyers and expanding the subsidy to refinancing is unnecessary. In addition, because these bonds are subject to the private bond volume cap and not unlimited in amount, the use of bond proceeds for refinancing by existing homeowners.

Prior Action

No prior action.

3. Repeal the five percent limit on unrelated or disproportionate private business use for governmental bonds

Present Law

In general

Subject to certain Code restrictions, interest on bonds issued by State and local government generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For this purpose, the term "nongovernmental person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Private activity bond tests

Present law provides three main tests for determining whether a State or local bond is in substance a private activity bond, the two-part private business test, the five-percent unrelated or disproportionate use test and the private loan test.

Private business test

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied–

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and

2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").

Private business use generally includes any use by a business entity (including the Federal government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.

Five percent unrelated or disproportionate business use test

A second standard to determine whether a bond is to be treated as a private activity bond is the five percent unrelated or disproportionate business use test. Under this test the private business use and private payment test (described above) is separately applied substituting 5 percent for 10 percent and generally only taking into account private business use and private payments which are not related or not proportionate to the government use of the bond proceeds. For example, while a bond issue that finances a new State or local government office building may include a cafeteria the issue may become a private activity bond if the size of the cafeteria is excessive (as determined under this rule).

Private loan test

The third standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Special limit on certain output facilities

A special rule for output facilities treats bonds as private activity bonds if more than $15 million of the proceeds of bond issue are used to finance an output facility (other than a facility for the furnishing of water)(sec. 141(b)(4)).

Special volume cap requirement for larger transactions

A special volume cap requirement for larger transactions treats bonds as private activity bonds if the nonqualified amount of private business use or private payments exceeds $15 million (even if that amount is within the general 10 percent private business limitation for governmental bonds) unless the issuer obtains a private activity bond volume allocation (sec. 141(b)(5)).

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond (sec. 141(e)). The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2011, the State volume cap, which is indexed for inflation, equals $95 per resident of the State, or $277.820 million, if greater.

Description of Proposal

The proposal repeals the five percent unrelated or disproportionate business use test.

Effective Date

The proposal is effective for bonds issued after the date of enactment.

Analysis

Proponents argue that the five percent unrelated or disproportionate business use test requires the issuer to perform a highly factual and detailed analysis which affects relatively small dollar amounts of bond proceeds. They continue that this test results in undue complexity given the several other present-law tests already applicable to such bond issues. Opponents do not

contest the undue complexity argument but tend to rely on the revenue loss from relaxed targeting as a reason for opposing it.

Prior Action

No prior action.

PART VIII − REDUCE THE TAX GAP AND MAKE REFORMS

A. Expand Information Reporting

1. Require information reporting on payments to corporations

Present Law

A variety of information reporting requirements apply under present law.[1183] These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments for services or determinable gains to any one payee aggregating $600 or more in any taxable year in the course of that payor's trade or business.[1184] Payments subject to reporting include fixed or determinable income or compensation, but do not include payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements.[1185] The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.[1186] The regulations generally provide exceptions from reporting of payments to corporations,[1187] exempt organizations, governmental entities, international organizations, or retirement plans.[1188] However, the following types of payments to corporations must be

[1183] Secs. 6031 through 6060.

[1184] Sec. 6041(a). Information returns are generally submitted electronically on Forms 1096 and Forms 1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2). The requirement that businesses report certain payments is generally not applicable to payments by persons engaged in a passive investment activity. However, for a brief period starting in 2011, the recipients of rental income from real estate were generally subject to the same information reporting requirements as taxpayers engaged in a trade or business such that recipients of rental income making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income were required to provide an information return to the IRS and to the service provider. Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2101 (Sept. 27, 2010). This rule was repealed in the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, sec. 3 (April 14, 2011).

[1185] Sec. 6041(a) requires reporting as to "other fixed or determinable gains, profits, and income (other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045)[.]" The payments thus excepted include most interest, royalties, and dividends.

[1186] Sec. 6041(d).

[1187] The regulatory carevout for payments to corporations was expressly overridden for payments made after December 31, 2011 in the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148, sec. 9006 (March 23, 2010) which expanded the class of payments subject to reporting to include payments to corporations and payments of gross proceeds paid in consideration for any type of property. However, these rules were repealed in the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, sec. 2 (April 14, 2011).

[1188] Treas. Reg. section 1.6041-3(p). Certain for-profit health provider corporations are not covered by this general exception, including those organizations providing billing services for such companies.

reported: Medical and health care payments;[1189] fish purchases for cash;[1190] attorney's fees;[1191] gross proceeds paid to an attorney;[1192] substitute payments in lieu of dividends or tax-exempt interest;[1193] and payments by a Federal executive agency for services.[1194]

Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).[1195] In general, the requirement to file Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of section 3406. Thus, a payor of interest, dividends or gross proceeds generally must request that a U.S. payee (other than certain exempt recipients) furnish a Form W-9 providing that person's name and taxpayer identification number.[1196] That information is then used to complete the Form 1099.

Failure to comply with the information reporting requirements results in penalties, which may include a penalty for failure to file the information return,[1197] and a penalty for failure to furnish payee statements,[1198] or failure to comply with other various reporting requirements.[1199]

[1189] Sec. 6050T.

[1190] Sec. 6050R.

[1191] Sec. 6045(f)(1) and (2); Treas. Reg. secs. 1.6041-1(d)(2) and 1.6045-5(d)(5).

[1192] *Ibid*.

[1193] Sec. 6045(d).

[1194] Sec. 6041A(d)(3). In addition, section 6050M provides that the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).

[1195] Secs. 6042 (dividends), 6045 (broker reporting) and 6049 (interest), as well as the Treasury regulations thereunder.

[1196] See Treas. Reg. sec. 31.3406(h)-3.

[1197] Sec. 6721. The penalty for failure to file an information return generally is $100 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed $1,500,000. Additionally, special rules apply to reduce the per-failure and maximum penalties where the failure is corrected within a specified period. Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2102 (September 27, 2010).

[1198] Sec. 6722. The penalty for failure to provide a correct payee statement is $100 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed $1,500,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement. Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2102 (September 27, 2010).

[1199] Sec. 6723. The penalty for failure to timely comply with a specified information reporting requirement is $50 per failure, not to exceed $100,000 for a calendar year.

Description of Proposal

The proposal repeals the additional information reporting requirements with respect to payments for property imposed by the PPACA, which have since been repealed.[1200] The proposal retains the requirement that businesses file an information return for payments for services or for determinable gains aggregating $600 or more in a calendar year to a corporation (except a tax-exempt corporation) and allows for regulatory authority to make appropriate exceptions where reporting would be especially burdensome.

Effective date.−This proposal is effective for payments made after December 31, 2011.

Analysis

The effect of the proposal would be to repeal the provisions in PPACA that required reporting with respect to payments made after December 31, 2011 for goods. It would retain the requirement to report payments made after December 31, 2011, to corporations. Since these two changes to the information reporting requirements were enacted by PPACA, critics have sought full[1201] or partial[1202] repeal. In support, they argue that the administrative burden (the need to get EINs from major corporations to whom payments are made, the need to track to whom payments are made, the cost of year-end preparation of multiple 1099's) on those subject to these prospective reporting obligations is disproportionate to any enhanced taxpayer compliance.

At the time the provisions were enacted, a complexity analysis suggested that the widespread use of computer technology to process and store business information would minimize the burden associated with generating and transmitting the information necessary to comply with the provision, regardless of the extent to which the taxpayer is currently subject to information reporting. The additional burden of expanded reporting would depend in part on the extent to which taxpayers subject to the provision already had adequate procedures and systems in place to comply with existing information reporting requirements. However, uncertainty about the scope of the expansion due to lack of administrative guidance would make it difficult for taxpayers to determine what steps would be necessary to comply with the expanded reporting.[1203] Repeal of the additional information reporting requirements with respect to purchases of goods would minimize but not eliminate the need for small businesses to develop new bookkeeping systems necessary in time for implementation of the expanded reporting in

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[1200] Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, sec. 2 (April 14, 2011).

[1201] See, Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, sec. 2 (April 14, 2011).

[1202] National Taxpayer Advocate, 2010 Annual Report to Congress, p. 374.

[1203] See, e.g., Government Accountability Office, *Costs and Uses of Third-Party Information Returns,* November 2007, GAO-08-266, available at <http://www/gao.gov/new.items/d08266.pdf>, wherein the GAO, based on its case studies, found the compliance costs associated with filing information returns to be "relatively low."

2011 and the need for the IRS to develop new forms and outreach programs to educate the public about the changes in reporting obligations.

The exemption from reporting with respect to payments to corporations was created by regulation and has existed for decades. Elimination of the exception for payments to corporations would simplify compliance with the reporting provisions by eliminating the need for the payor to ascertain the organizational form of the party providing the services. In support of its proposal to retain reporting of payments to a corporation, the Administration notes that the longstanding regulatory exception from information reporting for payments to corporations has created compliance issues. Since the regulation was first promulgated, the number and complexity of corporate taxpayers have increased. According to the GAO, only eight percent of approximately 50 million small businesses with less than $10 million in assets filed miscellaneous information return Form 1099-MISC.[1204] If greater reporting from small businesses were available, it is possible that the IRS could more readily identify areas of underreported income of the payees. In general, the more payments to which information reporting and/or withholding applies, the greater the improvement in compliance.[1205]

In the case of payments to tax-exempt or government entities that are generally not subject to income tax, information returns may not be necessary. In addition, categories such as regulated utilities, common carriers or publicly traded corporations may be appropriate exceptions in order to address concerns about overbreadth of reporting. Such exceptions could be addressed by identifying exceptions in any legislation, together with a grant of regulatory authority to exempt categories of corporations with respect to which the Secretary determines underreporting of receipts is not a serious compliance risk.

Prior Action

A similar proposal with respect to payments to corporations was included in the President's fiscal year 2011 and 2010 budget proposals.

2. Require information reporting for private separate accounts

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[1206] Similar favorable tax treatment is

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[1204] Government Accountability Office, *IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements,* GAO-09-238 (January 2009).

[1205] See, e.g., "Tax Year 2001 Individual Income Tax Underreporting Gap," <http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf> at 2, finding that information reporting is the primary differentiator in compliance rates. See also, Joseph Bankman, "Eight Truths About Collecting Taxes from the Cash Economy," 117 *Tax Notes* 506, 511 (2007).

[1206] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includable in income, to the extent

generally accorded an annuity or endowment contract. However, under the investor control doctrine, the holder of a variable life insurance or annuity contract is treated as the owner of the assets (such as mutual fund shares) underlying the contract if the holder's ability to direct the investment of those assets constitutes sufficient control over individual investment decisions.[1207]

Life insurance companies generally maintain assets that support liabilities under insurance contracts in a general account, or in separate accounts (in the case of certain types of contracts such as variable contracts). Present law imposes asset diversification requirements on separate accounts with respect to variable contracts. Under these diversification requirements, a variable contract that is based on a separate account is not treated as an annuity, endowment or life insurance contract for which investments made by the separate account are not adequately diversified (as prescribed in Treasury regulations), provided that the account satisfies applicable tax requirements.[1208] Separate financial reporting to State insurance regulators under statutory accounting rules is generally required for separate accounts, and separate financial statements, registration statements, and other reports may be required under Federal securities laws for separate accounts. For Federal income tax purposes, income, gain and loss of a separate account of a life insurer is reported on the Federal income tax return of the life insurer.

Description of Proposal

The proposal imposes reporting requirements with respect to a life insurance, endowment or annuity contract, if any portion of the cash value is invested in a private separate account, provided the investment represents at least 10 percent of the value of the account.

For this purpose, a private separate account is defined as any separate account of an insurance company with respect to which related persons hold annuity, endowment or life insurance contracts whose aggregate cash values represent at least 10 percent of the value of the assets in the separate account. The determination of whether related persons hold contracts whose aggregate cash values constitute at least 10 percent of the value of the assets in the separate account is made quarterly.

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that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

[1207] See Rev. Rul. 81-225, 1981-2 C.B. 13; *Christofferson v. U.S.*, 749 F.2d 513 (8th Cir. 1984); Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2007-7, 2007-1 C.B. 468.

[1208] Sec. 817(h).

The proposal requires a life insurance company maintaining a private separate account to report to the IRS with respect to each such contract the taxpayer identification number of the contract holder, the policy number, the amount of inside buildup, the total contract account value, and the portion of the total contract account value for each such contract that is invested in one or more private separate accounts of the life insurance company.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

The proposal reflects a concern that private separate accounts of life insurance companies may function to allow annuity, endowment, and life insurance contract holders to defer tax on investments that should be payable currently because the contract holders have control over the underlying investments. Proponents of the proposal argue that reporting to the IRS of information about the private separate accounts and the contracts that are based on them is needed to permit investigation of whether investor control is sufficient that the arrangement should be treated as direct holding of the assets, rather than holding of an annuity, endowment or life insurance contract, the inside buildup on which is tax-free. Without detailed reporting of information about the contracts and the accounts, identification and analysis of these arrangements is more difficult and leads to inefficient use of government resources.

However, opponents may assert that the reporting requirements are significantly broader than needed to identify cases in which the investor control doctrine might apply. If any reporting requirement is needed, it should be merely a notation that the arrangement exists. It is unclear that the reported information could actually be processed by the IRS in a useful manner; possibly the information might even be disregarded. In fact, reporting requirements designed merely to permit IRS identification of arrangements that might be challenged by the IRS is wasteful not only of government resources but also of taxpayer resources. Opponents may further argue that the detailed reporting requirements of the proposal are burdensome for taxpayers and give rise to excessive administrative costs without targeting any identified tax abuse. On the other hand, reporting may be a more efficient use of resources so that arrangements that require further investigation can be identified for audit.

Opponents may believe that the definition of a private separate account is broader than needed to achieve the goal of flagging questionable arrangements for audit. If the purpose of the definition is to identify an insurance company separate account that is owned principally by a particular person or group of related persons that might have the ability to direct the investments in the account in violation of the investor control doctrine, then the proposal's 10-percent ownership threshold could be criticized as too low or as arbitrary.

Advocates of the proposal may counter that the definition is for purposes of a reporting requirement, not a substantive provision of law. Taxpayers who are confident that their arrangement does not violate the investor control doctrine should not be concerned about reporting it.

Opponents may also take the position that the investor control doctrine perhaps is unlikely to apply with respect to private separate account contracts. One argument for this position might be that the diversification requirements of section 817(h) have superseded the investor control doctrine. Nevertheless, others may point out that the rules of section 817(h) and the investor control doctrine continue to coexist, as evidenced by the publication of several revenue rulings on the scope of the investor control doctrine long after the enactment of the section 817(h) diversification requirements.[1209] Another argument for this position is that the arrangements under private separate accounts are carefully monitored by the contract holder and the life insurance company so that they do not violate either the investor control doctrine or the diversification requirements. On the other hand, proponents of reporting assert that violations of the investor control doctrine, if they occur, arguably are more likely to take place in the context of private separate accounts, as compared to other types of insurance company accounts.

Prior Action

A similar proposal was included in the President's fiscal year 2001, 2010, and 2011 budget proposals.

3. Require a certified taxpayer identification number from contractors and allow certain withholding

Present Law

Information reporting

A taxpayer identification number ("TIN") is an identification number used by the IRS for purposes of tax administration. A TIN must be furnished on all returns, statements, or other tax related documents.[1210] Additionally, a person ("payee") must furnish his or her TIN to another person ("payor") if the payor is required to file a return, statement, or other tax related document that must include the payee's TIN.[1211]

Present law imposes a variety of information reporting requirements on participants in certain transactions.[1212] These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business to a single payee, including a corporation.[1213] Payments subject to reporting

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[1209] See Rev. Ruls. 2003-91, 2003-92, and 2007-7, *supra*. Section 817(h) was enacted in 1984, in section 211 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369.

[1210] Sec. 6109(a)(1).

[1211] Sec. 6109(b).

[1212] Secs. 6031 through 6060.

[1213] Secs. 6041(a), (h). The information return is generally submitted electronically as a Form-1096 and Form-1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2,

include payments or compensation for both goods and services. Special information reporting requirements exist for employers that are required to deduct and withhold tax from employees' income.[1214]

Government entities are specifically required to make an information return, reporting certain payments to corporations as well as individuals. Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).[1215]

As noted above, a payor required to make a return with respect to a payee must ask the payee for his identifying TIN and include that number in the return.[1216] Typically, if there is an error in the TIN-name combination furnished by the payee, the IRS may disclose such error to the payor. If the IRS has notified a payor of an incorrect payee TIN, the payor must withhold taxes from any reportable payments to the payee.[1217]

Withholding

Many payments are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors). Since contractors are not subject to withholding, they may be required to make quarterly payments of estimated income taxes and self-employment taxes. The contractor is required to pay any balance due when the annual income tax return is subsequently filed.

Description of Proposal

Certified TINs

Under the proposal, a contractor receiving payments of $600 or more in a calendar year from a particular business[1218] is required to furnish to the business the contractor's certified TIN. A business is required to verify the contractor's TIN with the IRS, which is authorized to

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respectively. Treas. Reg. sec. 1.6041-1(a)(2). The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, sec. 9006 adds new sec. 6041(h), which extends the information reporting requirement to payments made to corporations. Pub. L. No. 111-148, sec. 9006 also amends the definition of payments in sec. 6041(a) to include gross proceeds paid in consideration for property or services.

[1214] Sec. 6051.

[1215] Sec. 6050M.

[1216] Sec. 6109(b).

[1217] Sec. 3406(a)(1).

[1218] Treasury has indicated that "a particular business" refers to service recipients (including any governmental unit) who are required to report the payments under current section 6041A.

disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records.[1219]

Withholding

If a contractor fails to furnish an accurate certified TIN, the business (payor) is required to withhold a percentage of gross payments. Contractors receiving payments of $600 or more in a calendar year from a particular business could require the business to withhold a flat rate percentage of their gross payments, with the percentage of 15, 25, 30 or 35 percent being selected by the contractor.

Effective date.−The proposal is effective for payments made to contractors after December 31, 2011.

Analysis

The IRS receives a significant number of information returns each year containing missing or incorrect name and TIN information.[1220] For example, the rate of misreporting of wages and salaries is 1.2 percent.[1221] The IRS has indicated that amounts subject to third-party information reporting but not withholding have a higher misreporting percentage. For example, the misreporting rate for interest and dividends is 4.5 percent.[1222] Amounts generally subject to neither withholding nor third party information reporting, such as sole proprietor income and "other income," are the most likely to be misreported. The IRS has indicated that the net misreporting percentage for this group of items is 53.9 percent.[1223]

In light of these statistics, proponents may argue that compliance will be enhanced if payors have the ability to verify payee TINs with the IRS prior to filing information returns for reportable payments on behalf of such payees. In general, the compliance rate is high when there is both information reporting and withholding.[1224]

[1219] The IRS will not provide the correct TIN in response to an incorrect TIN submission; the IRS will state only that the information does not match IRS records.

[1220] For example, the Branch Chief for the Information Return Processing Branch has indicated that, in 2008, almost thirty million social security numbers filed on information returns (out of slightly over 2 billion forms filed) were unmatchable.

[1221] Testimony of Mark Everson, Commissioner of Internal Revenue, before the Senate Committee on the Budget, *FY 2008 IRS Budget and the Tax Gap*, February 14, 2007, p. 15.

[1222] *Ibid.*

[1223] *Ibid.*

[1224] Internal Revenue Service, Treasury Department, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2, 2007, p. 12.

Because the proposal requires withholding on gross proceeds, rather than taxable income, the proposal may result in excess withholding (because there is no accounting for the standard deduction, itemized deductions, or personal exemptions) on payments for which an accurate certified TIN is not provided. On the other hand, compliance could be enhanced because the IRS will have in hand the amounts withheld in the event that the contractor failing to supply the TIN also fails to report the income.

Those opposed to the proposal may argue that where a contractor is a sole proprietor and does not apply for a separate TIN but rather uses his social security number ("SSN"), the contractor may have concerns about identity theft in supplying the SSN to third parties. In the case of a tax-compliant taxpayer, the failure to supply a TIN may result in unnecessary withholding and cause hardship resulting from the decreased cash flow. Further, a payor may be forced to delay making a full payment for a contactor's services while waiting for the IRS to certify the TIN. On the other hand, the fact that income from sole proprietorships is among the categories of income most likely to be misreported may justify placing an additional burden on the compliant, as well as noncompliant, to ensure that taxes due and owing are paid.

Those opposed may also argue that giving a contractor a unilateral option to impose withholding requirements at varying rates on a business payor that might not otherwise engage in such withholding may impose an administrative paperwork and remittance burden on the payor with no recourse for the payor. On the other hand, the compliance burden on the contractor might be reduced as funds would be set aside to meet its tax obligation.

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009, 2010, and 2011 budget proposals.

B. Improve Compliance by Business

1. Require greater electronic filing of returns

Present Law

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[1225] states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

Present law requires the Secretary to issue regulations regarding electronic filing and specifies certain limitations on the rules that may be included in such regulations.[1226] The Secretary may permit, but generally cannot require, electronic filing of income tax returns of individuals, estates, and trusts. However, income tax returns prepared by specified tax return preparers are required to be filed electronically.[1227] In crafting the required regulations, the Secretary must take into account the ability of taxpayers to comply at reasonable cost.

The statute requires that the Secretary mandate electronic filing by all partnerships with more than 100 partners. For taxpayers other than partnerships, the Secretary is prohibited from requiring electronic filing by persons who file fewer than 250 returns during a calendar year.

The regulations require corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. Private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns for tax years ending on or after December 31, 2006, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer.

Effective for tax years ending on or after December 31, 2004, the IRS requires corporations with total assets in excess of $10 million to file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More). Effective for tax years ending on or after December 31, 2006, the Schedule M-3 filing requirement also applies to

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[1225] Pub. L. No. 105-206.

[1226] Sec. 6011(e). Partnerships with more than 100 partnerships with more than 100 partners are required to file electronically. Sec. 6011(e)(2).

[1227] Section 6011(e)(3)(B) defines a "specified tax return preparer" as any return preparer who reasonably expects to file more than 10 individual income tax returns during a calendar year.

the following entities with assets in excess of $10 million: S corporations; life insurance and property and casualty insurance companies; cooperative associations; and partnerships.

Description of Proposal

The proposal requires all corporations and partnerships required to file Schedule M-3 to file income tax returns electronically. In the case of large taxpayers not required to file Schedule M-3, including exempt organizations, the proposal provides regulatory authority to require electronic filing without regard to the present-law 250 return minimum.

The proposal requires the Secretary to balance the benefits of electronic filing against any burden that might accrue to taxpayers. Implementation of the proposal is to take place incrementally to afford adequate time for transition to electronic filing. The Secretary is permitted to provide waivers to taxpayers who cannot meet the electronic filing requirement due to technological constraints, undue financial burden, or other reasons specified in regulations.

Effective date.−The proposal is effective for tax years ending after December 31, 2011.

Analysis

The proposal generally seeks to allow Treasury to issue regulations requiring electronic filing by organizations without regard to the number of returns an organization files during the calendar year. As noted above, under present law, Treasury and IRS are generally precluded from requiring a person to file electronically if that person files fewer than 250 returns during the calendar year.

RRA 1998 set a goal for the IRS to have 80 percent of tax returns filed electronically by 2007. That goal has not been met, as of the 2009 tax filing season.[1228] However, growth in electronic filing is slowing and the IRS has reported that the goal set by Congress will not be achieved.[1229] Providing Treasury and the IRS with greater flexibility to expand the scope of returns that are required to be filed electronically may be helpful to the IRS in achieving the 80 percent goal set by the Congress.

Electronic filing produces a number of benefits both for taxpayers and the IRS, including shorter processing times, fewer errors, and better data. Proponents argue that the efficiencies and cost savings achieved through electronic filing justify expanding such requirements. For example, the GAO has reported that electronic filing has enabled the IRS to close two processing

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[1228] GAO reports that for the 2009 season, electronic filing increased to 56.7 percent for the major returns subject to the 80 percent goal. See, Government Accountability Office, GAO-11-344, *Electronic Tax Return Filing: Improvements Can Be Made Before Mandate Becomes Fully Implemented* (March 2011).

[1229] See, e.g., Government Accountability Office, GAO-07-27, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings* (November 2006). This report indicates a slowing growth in individual electronic filing for the 2005 return filing season. The number of corporations using electronic filing increased during the same period largely as a result of early adoption of electronic filing by corporations with assets of $10 million or more.

centers, and save 1,600 staff years of work.[1230] With the widespread adoption of computer technology, proponents contend that mandatory e-filing represents a minimal additional burden to taxpayers.

On the other hand, opponents argue that expanding electronic filing mandates will impose at least a one-time additional cost on taxpayers who will be required to submit tax returns and related schedules in a new format. Moreover, they assert that most of the costs of electronic filing are borne by taxpayers while most of the benefits accrue to the government. In addition, even if taxpayers have the necessary systems to meet expanded electronic filing requirements, the expected benefits from the proposal will be realized only to the extent the IRS has sufficient resources to effectively analyze the transmitted data.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, 2008, 2009, 2010, and 2011 budget proposals.

2. Allow additional information required under the Code to be included in electronically filed Form 5500 reports

Present Law

Code section 6058 requires every sponsor who maintains a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation (or the plan administrator the plan) to file an annual return containing such information as prescribed in regulations with respect to qualification, financial condition, and operation of the plan. Section 6059 requires that a defined benefit pension plan subject to the minimum funding requirements of section 412 annually file an actuarial report prepared by an enrolled actuary. Similarly, sections 103 and 104 of Title I of the Employee Retirement Income Security Act of 1974[1231] ("ERISA") requires that certain pension and welfare benefit plans file an annual report disclosing certain information to the Department of Labor (DOL). These Code and ERISA filing requirements have been consolidated into a single series of forms (Form 5500 and attachments) that is filed with the DOL and then shared with the IRS. This filing serves as the primary tool for gathering information and for appropriate targeting of enforcement activity regarding such plans. It also serves to satisfy certain requirements for filing with the Pension Benefit Guaranty Corporation.

The DOL has the authority to require electronic filing of information relevant to Title I of ERISA and has exercised its authority to require that Form 5500 and its attachments be filed electronically. The DOL regulations under section 104 require electronic filing for all filers for

[1230] *Ibid.*

[1231] Pub. L. No. 109-8.

plan years beginning on or after January 1, 2009.[1232] No paper filings of any kind (e.g., mail, fax) will be accepted beginning January 1, 2010, except for timely filed 2008 plan year filings.

However, under section 6011(e), the Department of Treasury and IRS are not permitted to require electronic filing of returns unless the person subject to the filing requirement must file at least 250 returns during the year. As a result, information previously collected on the paper Form 5500 and relevant only to Internal Revenue Code requirements (such as data on coverage needed to test compliance with nondiscrimination rules) and not relevant to DOL's ERISA Title I jurisdiction cannot be requested on the electronically-filed joint Form 5500 and currently is not collected. Collecting it would require a separate "IRS only" form.

Description of Proposal

The proposal provides authority to the IRS to require employers required by DOL to file Form 5500 electronically to include in the electronically filed Form 5500 information that is relevant only to employee benefit plan Internal Revenue Code requirements. Thus, IRS would have the authority with respect to such tax information, comparable to the present-law authority of DOL, to require electronic filing of the Form 5500 with respect to information relevant to ERISA Title I.

Effective date.−The proposal is effective for plan years beginning after December 31, 2011.

Analysis

Advocates of the proposal point out that the structure of current paper and electronic filing rules virtually eliminates the reporting requirement with respect to information relevant only to Internal Revenue Code requirements such as data on coverage needed to test compliance with nondiscrimination rules. It is neither practical nor feasible to separately require this information to be provided in a separate paper Form 5500, a process that would be neither simple nor efficient for taxpayers or for the IRS or DOL. Employers maintaining funded retirement plans are already required to file Form 5500 electronically, so the incremental burden on employers of including this additional information is not significant. Further, the use of computers for business information sharing and record keeping is generally now routine.

Others may argue that the rule in section 6011(e) limiting the ability of the IRS to mandate electronic filing by business entities should be reevaluated more broadly. They may assert that carving out a narrow exception for Form 5500 is inefficient and fails to take account of the advantages of broader requirements for electronic filing.

Prior Action

No prior action.

[1232] 29 C.F.R. 2520.104a-2.

3. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[1233]

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 of wages 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 ($106,800 for 2011). The HI tax rate is, generally, 1.45 percent of wages on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax the HI tax is generally not limited to a specific amount of wages, but applies to all wages. Under PPACA, however, the employee portion of the HI tax was increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount.[1234] Unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

FUTA tax is used to fund programs maintained by the individual States for the benefit of unemployed workers. Under FUTA, employers must pay a tax of 6.2 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 mean 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.[1235]

[1233] Secs. 3101-3128 (FICA), 3201-3241 (the Railroad Retirement Tax Act), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[1234] Sec. 3121(a) of PPACA.

[1235] The SUTA Dumping Prevention Act of 2004, Pub. L. No. 108-295, set standards for State law to prevent the practice of "SUTA dumping," a tax evasion scheme where shell companies are formed to obtain low State unemployment insurance tax rates.

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.

Wages paid to employees, and FICA and income taxes withheld from the wages, are required to be reported on employment tax returns and on Form W-2.[1236]

Responsibility for employment tax compliance

Responsibility for employment taxes generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[1237] 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. In other words, the required relationship exists when 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 is often applied in determining whether a worker is an employee or an independent contractor; however, the same test is also used to determine whether a worker is an employee of one person or another.[1238]

In some cases, a person other than the common-law employer may be liable for employment taxes. For example, if wages are paid to an employee by a person other than the employer and the payor, rather than the employer, has control of the payment of the wages, the payor is responsible for complying with the applicable employment tax requirements.[1239] In

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[1236] Secs. 6011 and 6051.

[1237] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1(a).

[1238] Issues relating to the classification of workers as employees or independent contractors are discussed in Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), May 2007. These issues are also discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Vol. II, Part XV.A, pp. 539-550.

[1239] 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); and *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. 3d 989 (4th Cir. 1997).

addition, certain designated agents are jointly and severally liable with the employer for FICA tax and income tax withholding with respect to wages paid to the employer's employees (the "designated agent" rule).[1240] These designated agents prepare and file employment tax returns using their own names and employer identification numbers.[1241] In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients' returns. Reporting agents prepare and file employment tax returns for their clients using the client's name and employer identification number.

Employee leasing arrangements

An employee leasing company (sometimes called a professional employer organization) provides employees to perform services in the businesses of the employee leasing company's clients, which are usually small and medium-sized businesses. In many cases, the employees already work in the client's business as the client's employees prior to entry into the employee leasing arrangement. The terms of a typical employee leasing agreement provide that the employee leasing company is responsible for paying the employees and for the related employment tax compliance. While the employees may legally be the employees of the client, rather than of the employee leasing company, clients typically rely on the employee leasing company to satisfy applicable employment tax obligations.[1242] Despite these contractual provisions, the questions of whether the employee leasing company is, in fact, the common law employer of the employees (and therefore generally responsible for employment taxes) or whether the employee leasing company is a designated agent of the employer (and therefore joint and severally liable for employment taxes), is often the subject of dispute following a failure to remit employment taxes due.

Description of Proposal

The proposal contemplates the establishment of standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes and standards for holding employee leasing companies solely liable for such taxes if they meet specified requirements. Details of the proposal have not yet been provided.

[1240] Sec. 3504. The designated payroll agent rules do not apply for FUTA purposes.

[1241] The employer's name, address, and employer identification number, as well as the agent's, are provided when the agent is designated by the employer. Form 2678 is used to designate an agent.

[1242] As discussed in the text above, the issue of whether a worker is an employee of a particular entity for employment tax purposes is generally determined by reference to the Treasury regulations under sections 3121(d), 3306(i), and 3401(c), which incorporate the common law definition of employee. This common law definition also generally applies for purposes of determining who is an employee for retirement plan purposes. In some cases, a professional employer organization may provide benefits to workers who are legally the employees of the client. The IRS has issued guidance with respect to the application of the retirement plan rules in such cases. For example, Revenue Procedure 2002-21, 2002-1 C.B. 911, provides that employees of a client may be covered under a multiple employer defined contribution plan of the professional employer organization if the client adopts the plan and certain other requirements are satisfied. See also Rev. Proc. 2003-86, 2003-2 C.B. 1211.

Effective date.−The proposal is effective for employment tax returns filed with respect to wages paid after December 31, 2011.

Analysis

In the absence of a detailed proposal, the following analysis discusses general issues relating to employee leasing companies and employment taxes.

In a 2001 study of the tax gap, the IRS estimated that the portion of the gap attributable to FICA and FUTA taxes was $15 billion for the 2001 tax year.[1243] An additional portion of the tax gap is attributable to income taxes due on unreported wages. The proposal is aimed at improving employment tax compliance by businesses.

In an employee leasing arrangement, clients typically rely on the leasing company to comply with the applicable employment tax requirements. This is the case regardless of whether legal responsibility for employment tax compliance rests with the leasing company or with the client. In such a case, absent an audit, the IRS generally has no way of knowing whether the leasing company or the client is the employer, or even that a leasing arrangement exists. If neither the leasing company nor the client complies with the applicable employment tax requirements, it may be difficult to determine which party is liable for compliance.

Uncertainty as to who is responsible for employment tax compliance in an employee leasing arrangement may mean that, as a practical matter, no one is held responsible for the payment of employment taxes. Providing clear rules for determining who is liable for employment taxes in employee leasing arrangements would address those issues and could improve compliance. In addition, joint and several liability may make it more difficult for an employee leasing company to avoid employment tax liability with respect to wages paid to leased employees.

Some believe that holding leasing companies solely liable for employment taxes offers a greater likelihood of employment tax compliance than can be expected from clients on an individual basis, particularly in the case of clients that are small businesses.[1244] On the other hand, the payroll of a leasing company typically includes the payroll for employees leased to many client businesses, as well as the payroll for employees working directly for the leasing company itself. Accordingly, the failure of a leasing company to comply with employment tax obligations may result in noncompliance on a larger scale than the level of noncompliance that would otherwise occur among client businesses. In addition, the IRS has designated certain transactions involving the designation of an offshore employee leasing corporation as the employer, and therefore the party liable for the payment of employment taxes, as a listed

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[1243] IRS news release IR-2006-28 and attachment, February 14, 2006.

[1244] Such proponents observe that an employee leasing company should have an expertise in the proper handling of employee wages since the payment of wages is a core business function of such a company. Apart from employment tax compliance benefits, proponents of placing liability solely on employee leasing companies note that economies of scale permit leasing companies to provide their leased employees with benefits that cannot be provided on an affordable basis by their smaller clients.

transaction and has communicated its commitment to challenge the tax benefits claimed under these arrangements.[1245] Rules for holding leasing companies solely liable for employment taxes should therefore include adequate standards and procedural safeguards to prevent abuse and to assure that the leasing company will in fact comply with the new rules.

Some argue that existing rules, such as the designated agent rules, are sufficient to permit leasing companies to assume employment tax responsibility and thus there is no need for special rules (such as the proposal) under which only the leasing company is liable for a failure to pay employment taxes. Further, some note that, under a regime where employee leasing companies are solely liable for employment taxes, the IRS may be left without recourse when insufficiently capitalized leasing companies become insolvent and that the existing rules imposing joint and several liability in certain situations provide the IRS with some protection in this regard.

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009, 2010, and 2011 budget proposals.

4. Increase certainty with respect to worker classification

Present Law

Different tax treatment for employees and independent contractors

Significant tax consequences for both the service recipient and the worker result from whether a worker is an employee or an independent contractor. An independent contractor is a self-employed individual under the Code for purposes of income taxes and employment taxes. The tax consequences of a worker being an independent contractor, rather than an employee, relate to withholding and employment tax liability, as well as to the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Employment taxes

Federal Insurance Contributions Act ("FICA") tax

FICA tax applies to employers based on the amount of covered wages paid to an employee during the year. Generally, covered wages means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Certain exceptions from covered wages are also provided. FICA tax is composed of two

[1245] IRS Notice 2003-22, 2003-1 C.B. 851.

parts: (1) old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($106,800 in 2010); and (2) Medicare hospital insurance ("HI") tax equal to 1.45 percent of covered wages.

In addition to the tax on employers, except for a temporary reduction for 2011, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer.[1246] The employee portion of the FICA tax generally must be withheld and remitted to the Federal government by the employer.[1247] The employer generally is liable for the amount of this tax whether or not the employer withholds the amount from the employee's wages.[1248] In the event that the employer fails to withhold from an employee, the employee generally is not liable to the IRS for the amount of the tax. However, if the employer pays its liability for the amount of the tax not withheld, the employer generally has a right to collect that amount from the employee. Further, if the employer deducts and pays the tax, the employer is indemnified against the claims and demands of any person for the amount of any payment of the tax made by the employer.[1249]

Federal Unemployment Tax Act ("FUTA")

FUTA tax is used to fund programs maintained by the individual States for the benefit of unemployed workers. Under FUTA, for 2010, employers must pay a tax of 6.2 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 mean 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.[1250] As a result of the credits, in almost all cases, the net FUTA tax rate is 0.8 percent.

[1246] Sec. 3101. However, under section 9015 of PPACA, for remuneration received and taxable in years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. There is no corresponding increase on the employer portion of FICA.

[1247] Sec. 3102(a).

[1248] Sec. 3102(b).

[1249] *Ibid.*

[1250] The SUTA Dumping Prevention Act of 2004, Pub. L. No. 108-295, set standards for State law to prevent the practice of "SUTA dumping," a tax evasion scheme where shell companies are formed to obtain low State unemployment insurance tax rates.

Wage reporting and income tax withholding

Income tax withholding applies to wages paid to employees by an employer. An employer is generally liable for income taxes required to be withheld even if the employer fails to withhold.[1251] This liability is only abated if the income taxes against which such tax may be credited are paid by the employee.[1252] However, this abatement does not relieve the employer of any penalty or addition to tax otherwise applicable as a result of any failure to initially deduct and withhold income taxes.[1253]

Wages, and the amount of income tax and FICA taxes withheld from an employee, must be reported on Form W-2.[1254] There is no withholding required with respect to payments by service recipients to independent contractors. However, amounts paid to independent contractors for services in excess of $600 for a taxable year must be reported on Form 1099.[1255]

Liabilities and penalties imposed on employers for failure to withhold payroll taxes

Section 3505(a) imposes liability for FICA taxes on any person who pays wages directly to an employer's employees. Subject to a limit of 24 percent of the proceeds involved, any person who supplies funds to an employer for the specific purpose of paying wages to the employer's employees is liable under section 3505(b) for the amounts to be withheld if, and only if, the person has notice or knowledge that the employer is not meeting, or cannot meet, its withholding obligations.

The liability for failure to deduct and withhold is mitigated where the failure is due to the employer's treatment of the worker as an independent contractor,[1256] rather than an employee, but only if the failure is not due to an intentional disregard of the duty to deduct and withhold. Under this reduced liability, the employer's liability for income tax withholding is limited to 1.5 percent of wages, and liability for the employee portion of FICA is limited to 20 percent of the amount actually owed. However, if the employer fails to issue Forms 1099 to employees reporting amounts paid to the employees treated as independent contractors, the liability is increased to three percent of wages for income tax withholding and 40 percent of the employee portion of FICA. In either case, there is no mitigation of liability for the employer portion of FICA, and no credit is provided for any tax paid by the employee or right to claim reimbursement from the employee.

[1251] Sec. 3402(a)

[1252] Sec. 3402(d)

[1253] *Ibid*.

[1254] Sec. 6051.

[1255] Sec. 6041.

[1256] Sec. 3509.

In addition to other penalties provided by law, the Code provides for collection of unpaid withholding, FICA, and FUTA taxes by imposing personal liability on "responsible persons," meaning persons (e.g., officers, employees, and directors) required to collect, truthfully account for, and pay over any tax imposed by the Code on an employer. If a responsible person willfully fails to collect, pay over, or account for taxes, or otherwise attempts to do defeat the tax, a so-called 100 percent penalty[1257] is assessed. The penalty is an amount equal to the total taxes evaded, not collected, or not accounted for or paid over. It does not include any interest or penalties that the employer may be liable for with respect to the unpaid taxes. Criminal penalties for willful failures may also be incurred.

Self-Employment Contributions Act ("SECA") tax

As a parallel to FICA, SECA tax applies to the net income from self-employment of self-employed individuals, including independent contractors.[1258] The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer portions of the OASDI tax rates under FICA and apply to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is 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.[1259]

Worker classification for employment tax liability

In general

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test under common law that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also as to the circumstances under which it is performed.[1260] However, under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes

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[1257] Sec. 6672.

[1258] For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's 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 the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

[1259] Under section 9015 of PPACA, an additional tax of 0.9 percent of self-employment income (parallel to the additional HI portion of the FICA tax) applies to the HI portion of SECA for taxable years beginning after December 31, 2012.

[1260] Generally the determination of whether a worker is an employee or independent contractor is referred to as worker classification. Because a service recipient is required to withhold income tax and FICA from an employee's wages, and is liable for payment of the employer portion of FICA, during a calendar year, and thus generally must take a position as to the worker's classification before the worker files an income tax return, the first classification of a worker is generally made by the service recipient.

even though, applying the common-law test, the facts and circumstances indicate that the worker is properly classified as an employee. This safe harbor applies if the service recipient has a reasonable basis for treating the worker as an independent contractor (including certain specified safe harbors) and certain other requirements are met. In some cases, the treatment of a worker as an employee or independent contractor is specified by statute.

Common-law test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test that has been incorporated into specific provisions of the Code or that is required to be used pursuant to Treasury regulations or case law. For example, section 3121(d)(2) (which defines terms for purposes of the Social Security taxes that apply to wages paid to an employee) generally defines the term "employee" to include any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. By contrast, section 3401 (which defines terms for purposes of an employer's Federal income tax withholding obligation with respect to wages paid to an employee) does not define the term "employee." However, regulations issued under section 3401 incorporate the common-law test.

The regulations under section 3401 provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[1261] Under the regulations, it is not necessary that the employer actually exercises control over the manner in which the services are performed, rather, it is sufficient that the employer has a right to such control.[1262] Whether the requisite control exists is determined based on all the relevant facts and circumstances.

The origin of the common-law test is the master and servant employment relationship as described in the Restatement (Second) of Agency. Under the Restatement, classification of a worker as a servant (that is, employee) rather than an independent contractor is based on a facts and circumstances determination. The facts are generally evaluated to determine the extent of the service recipient control. The principal difference between a servant and an independent contractor is the extent of control. In the case of a servant, by agreement, the master may exercise control over the details of the work, both with respect to the result the worker is to accomplish and the means by which such result is accomplished.[1263] Over the years, courts have

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[1261] Treas. Reg. sec. 31.3401(c)-(1)(b).

[1262] *Ibid.* See also *Gierek v. Commissioner,* 66 T.C.M. 1866 (1993) (involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control the worker regardless of the extent to which such control was actually exercised). See also, IRS Publication 1779 (Rev. 1-2005).

[1263] Restatement of Agency 2nd, sec. 220 (1958), *Nationwide Mutual Insurance Co. v. Darden,* 503 U.S. 318, and Alden J. Bianchi, "Employee Benefits for the Contingent Workforce," Tax Management Portfolio 399, p. A-9.

identified on a case-by-case basis various facts or factors that are relevant in determining whether a master-servant (that is, employer-employee) relationship exists.

In 1987, based on an examination of cases and rulings, the IRS developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.[1264] The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed; factors other than the listed 20 factors may also be relevant.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties.[1265] The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.[1266]

Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 ("section 530") generally allows a taxpayer who is a service recipient to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment or otherwise fails to meet

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[1264] Rev. Rul. 87-41, 1987-1 C.B. 296 (providing guidance with respect to section 530 of the Revenue Act of 1978). The 20 factors identified by the IRS are: (1) instructions (compliance with instructions required indicates employee status); (2) training (the provision of training by service recipient indicates employee status): (3) integration (integration of the worker's services into the business operations of service recipient indicates employee status); (4) services must be rendered personally (indication of employee status); (5) hiring, supervision, and paying assistants (if service recipient hires, supervises or pays assistants, it indicates employee status, but if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status); (6) continuing relationship (indicates employee status); (7) set hours of work (indicates employee status); (8) full time services required (indicates employee status); (9) work done on employer's premises (indicates employee status if work could be done elsewhere); (10) order or sequence test (indicates employee status if a worker must perform services in the order or sequence set by service recipient); (11) oral or written reports required (indicates employee status); (12) payment by the hour, week, or month (indicates employee status); (13) payment of business and/or traveling expenses (indicates employee status): (14) furnishing tools and materials by service recipient (indicates employee status); (15) significant investment by worker (indicates independent contractor status); (16) realization of profit or loss by worker (indicates independent contractor status); (17) working for more than one firm at a time (indicates independent contractor status); (18) making services available to the general public (indicates independent contractor status); (19) service recipient has right to discharge (indicates employee status); and (20) worker has right to terminate relationship (indicates employee status).

[1265] Department of the Treasury, Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I, p. 2-7. This document is publicly available through the IRS website.

[1266] *Ibid.* p. 2-3 through p. 2-7.

certain requirements. The relief provided to an employer under section 530 was initially a temporary measure (scheduled to terminate at the end of 1979) to give Congress time to resolve the many complex issues regarding worker classification. Section 530 was permanently extended in 1982 and later revised.[1267]

Under section 530, a reasonable basis for treating a worker as an independent contractor is deemed to exist if the taxpayer reasonably relied on: (1) past IRS audit practice with respect to the taxpayer, (2) published rulings, technical advice with respect to the taxpayer, or judicial precedent, or (3) long-standing recognized practice of a significant segment of the industry in which the taxpayer is a member. With respect to the industry practices safe harbor, section 530 specifically provides that the significant segment requirement does not require more than 25 percent of the industry (determined without taking the taxpayer into account). The "long-standing" requirement does not require the practice to have continued for more than 10 years and the practice does not fail to be long standing merely because it began after 1978. In addition, a taxpayer can rely on any "other reasonable basis" for treating a worker as an independent contractor.

The relief under section 530 is available with respect to a worker only if certain additional requirements are satisfied. The taxpayer must not have treated the worker as an employee for any period, and for periods after 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position to the worker as an employee for purposes of employment taxes for any period beginning after 1977 (the "similar worker consistency requirement").

The similar worker consistency requirement does not apply with respect to services performed after December 31, 2006, by an individual who provides services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations.[1268] This exception only applies if the service recipient is an organization that is described in section 501(c) and the service provider is not otherwise treated as an employee of the organization for employment tax purposes.

Section 530 does not apply in the case of a worker who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[1269] Thus, the determination of whether such workers are employees or independent contractors for purposes of employment taxes is made in accordance with the common-law test.

[1267] Section 530 was extended through the end of 1980 by Pub. L. No. 96-167 and through June 30, 1982, by Pub. L. No. 96-541. It was permanently extended by the Tax Equity and Fiscal Responsibility Act of 1982. A number of changes to section 530 were made by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, and the Pension Protection Act of 2006.

[1268] Section 864 of the Pension Protection Act of 2006.

[1269] Section 1706 of the Tax Reform Act of 1986.

Section 530 also prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes.[1270] However, in response to a taxpayer request, the IRS may issue a written determination regarding the status of a particular worker as an employee or independent contractor for purposes of Federal employment taxes and income tax withholding.[1271]

Moreover, section 530 only applies to the service recipient and only applies for purposes of employment taxes. Thus, if a service recipient treats a worker as an independent contractor, the worker is not required to take a consistent position on the worker's tax return if, under the common-law test, the worker is an employee.

Section 530 does not apply for other employee benefit purposes that use the common-law test for determining who is an employee, such as the coverage requirements for qualified retirement plans under section 401(a) and ERISA.

Statutory employees or independent contractors

The Code contains various provisions that prescribe treatment of a specific category or type of worker as an employee or an independent contractor. Some of these provisions apply for Federal tax purposes generally; for example, certain real estate agents and direct sellers are treated for all tax purposes as not being employees.[1272] Others apply only for specific purposes; for example, full-time life insurance salesmen are treated as employees for social security tax and employee benefit purposes,[1273] and certain salesmen are treated as employees for social security tax purposes.[1274]

Worker classification tests under other Federal laws and State laws

Federal labor laws

A worker's status as independent contractor or employee is relevant for a number of Federal labor laws. Generally, employees are protected under these laws but independent contractors are not.[1275] In *Nationwide Mutual Insurance Co. v. Darden*, the Supreme Court held

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[1270] Rev. Rul. 87-41 (described above) provides guidance with respect to section 530 of the Revenue Act of 1978.

[1271] IRS Form SS-8 (Rev. 11-2006). A written determination with regard to prior employment status may be issued by the IRS. The IRS will not issue a written determination with respect to prospective employment status. Rev. Proc. 2007-3, 2007-1 I.R.B. 108.

[1272] Sec. 3508.

[1273] Sec. 3121(d)(3)(B) and 7701(a)(20).

[1274] Sec. 3121(d)(3)(D).

[1275] G.J. Stillson MacDonnell, "Independent Contractor Status under Federal Labor and Employment Laws," Robert E. Wood, *Legal Guide to Independent Contractor Status, Fourth Ed.*, Tax Institute, San Francisco, CA (2007), Chapter 5. Examples of these laws are Title VII of the Civil Rights Act of 1964; the Age Discrimination

that, under Federal law, the common-law test applies to determine who is an employee where no definition is specified.[1276] However, the Supreme Court in *Nationwide Mutual Insurance Co.* indicated that a different result can be reached when the statue does more than refer to employees. As an example, the Court indicated that the Fair Labor Standards Act ("FLSA") defines the verb "employ" expansively to mean "suffer or permit to work." The Court pointed out that this definition "stretches the meaning of the word 'employee' to cover parties who might not qualify as such under a strict application of traditional agency law principles."[1277] With respect to the FLSA, the Supreme Court has found that the classification of a worker as an employee should not be bound by the limits of the common law of agency but instead should be based on the underlying "economic realities" of the relationship between the worker and the service recipient ("economic realities test").[1278]

ABC test under certain State unemployment laws

Many States apply a standard for State unemployment tax that sweeps in most workers – popularly referred to as the "ABC test" (so called because of its three-pronged approach). While different States have slightly different tests, they generally include the same basic requirements. As an illustration, the Maryland ABC test provides that a worker is not an employee if:

1. The individual who performs the work is free from control and direction over its performance both in fact and under the contract;

2. The individual customarily is engaged in an independent business or occupation of the same nature as that involved in the work; and

3. The work is (1) outside of the usual course of business of the person for whom the work is performed, or (2) performed outside of any place of business of the person for whom the work is performed.[1279]

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in Employment Act ("ADEA"); the Fair Labor Standards Act ("FLSA"); the National Labor Relations Act ("NLRA"); the Employee Retirement Income Security Act (ERISA); and the Family and Medical Leave Act ("FMLA").

[1276] 503 U.S. 318 (1992).

[1277] *Ibid*., p. 326.

[1278] *Goldberg v. Whitaker House Cooperative,* 366 U.S. 28 (1961) and *Rutherford Food Corp v. McComb*, 331 U.S. 722 (1947).

[1279] MD Code, Labor and Employment, sec. 8-205 (available at http://www.michie.com/maryland/lpext.dll?f=templates&fn=main-h.htm&2.0). For a further discussion of the ABC test, see Robert E Wood, *Legal Guide to Independent Contractor Status, Fourth Ed*., p. 1.09, and Andrew Stettner, Rebecca Smith, and Rick Mc Hugh, *Changing Workforce, Changing Economy*, National Employment Law Project, New York, N.Y. (2004), pp. 34-35.

Description of Proposal

The proposal generally permits the IRS to require prospective reclassification of workers who are currently misclassified by service recipients but whose reclassification has been prohibited under the present-law section 530 safe harbor.

Treasury and the IRS are also permitted to issue generally applicable guidance on the proper classification of workers under common-law standards, thereby enabling service recipients to properly apply those standards, and minimizing concerns that an IRS examination would produce a different result. In developing any such guidance, Treasury is directed to interpret the common law in a neutral manner recognizing that many workers are, in fact, not employees. Such guidance is to include narrowly defined safe harbors and/or rebuttable presumptions. To make the guidance clearer and more useful for service recipients, a substantial portion of the published guidance is expected to be industry-specific or job-specific. Priority for the development of guidance is to be given to industries and jobs in which application of the common-law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been historical failures to report compensation paid.

Present-law reduced penalties for misclassification are retained, except that lower penalties apply only if the service recipient voluntarily reclassifies its workers before being contacted by the IRS or another enforcement agency and if the service recipient has filed all required information returns (Forms 1099) reporting the payments to the workers. For service recipients with only a small number of employees and a small number of misclassified workers, penalties (including reduced penalties) may be waived if the service recipient (1) consistently filed Forms 1099 reporting all payments to all misclassified workers, and (2) agrees to prospective reclassification of misclassified workers. It is anticipated that, after enactment, new enforcement activity will focus mainly on obtaining the proper worker classification prospectively, since in many cases the proper classification of workers may not have been clear.

Under the proposal, service recipients are required to give notice to independent contractors when they first begin performing services for the service recipient. Such notice must explain how they will be classified and the consequences thereof (e.g., tax implications, workers' compensation implications, and wage and hour implications).

The IRS is permitted to disclose to the Department of Labor information about service recipients whose workers are reclassified.

To ease compliance burdens for independent contractors, independent contractors receiving payments totaling $600 or more in a calendar year from a service recipient are permitted to require the service recipient to withhold, for Federal tax purposes, a flat rate percentage of their gross payments, with the flat rate percentage being selected by the contractor.

Effective date.−The proposal is effective upon enactment, but prospective reclassification of those covered by section 530 is not effective until the first calendar year beginning at least one year after date of enactment. A transition period of up to two years is provided for independent contractors with existing written contracts establishing their status.

Analysis

Common-law test

The proposal permits IRS to require prospective compliance with the common-law test, as interpreted in Treasury guidance, for all taxpayers for purposes of employment taxes, including service recipients entitled to rely on section 530 under present law. Critics of the common-law test point out that a major source of the confusion regarding classification of a worker is that the common-law test requires an examination of a variety of factors that often do not result in a clear answer. Although the proper classification of a worker is clear in many circumstances, in close cases, the law creates a significant gray area that leads to complexity, with the potential for inadvertent errors.[1280] They argue that a more objective standard is needed for worker classification that leaves fewer situations unclear.

Critics of the common-law test argue that the test, when combined with what they characterize as the bias of the IRS toward classification of workers as employees, leaves service recipients vulnerable to being second guessed by IRS agents on audit. However, others argue that the common-law test places too great an emphasis on "control" by service recipients and can be manipulated by them. They argue that a test, such as the ABC test or the economic realities test, that expands the workers that must be classified as employees may be necessary to counter balance the strong incentive for service recipients to treat workers as independent contractors and the lack of bargaining power of workers being misclassified to demand employee treatment.

Adoption of a standard other the common-law test requires a foundation in the relevant statutory language.[1281] Thus, absent statutory language that supports a broader definition of employee, such a change would be difficult for Treasury to undertake through regulations alone.

Published guidance on worker classification

As discussed above, since the enactment of section 530, the Treasury and the IRS have been prohibited from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes. The resulting lack of current

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[1280] Under the common-law test, some factors may support employee status, while others may support independent contractor status. No guidance is provided for how to weigh any particular factor. In addition, some factors involve an examination of objective facts, while others involve an examination of subjective facts or an examination of a combination of objective and subjective facts. Because the determination of proper classification requires weighting the specific facts, reasonable people may differ as to the correct result given a certain set of facts. Thus, for example, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by weighing some of the relevant factors differently than the taxpayer. Similarly, a worker and a service recipient may reach different conclusions as to the proper classification of the worker.

[1281] See *Nationwide Mutual Insurance Co. v. Darden*, *supra*. However, some courts use a combination of the factors under the common-law test and economic realities test, reasoning that the common law allows all aspects of the working relationship to be considered. This approach generally arises in the context of Title VII cases. See, for example, *Wilde v. County of Kandiyohi*, 13 F. 3d 103 (8th Cir. 1994) and *Frankel v. Bally*, 987 F. 2d 86 (2nd Cir. 1993)

guidance contributes to the lack of clarity in the law and increases the likelihood of inadvertent misclassification of workers. Previously issued guidance may not reflect current case law, statutory changes, or changes in workplace situations. Without appropriate guidance, not only are differences between taxpayers and the IRS more likely, but different IRS agents may reach different conclusions on the law as well as the relevant facts, resulting in increased inconsistent enforcement.[1282]

Thus, most would agree that allowing the IRS and Treasury to again issue published guidance of generally applicability, including regulations, is likely to improve worker classification compliance. However, the extent of this improvement depends on the guidance itself. Some argue that the strong bias that they perceive the IRS as having toward classification of workers as employees is likely to be reflected in any published guidance. They argue that this concern was an impetus for the provision in section 530 precluding IRS from issuing published guidance.

The proposal is designed to allay these concerns in a number of ways. First, the proposal specifies that the IRS and Treasury are to develop guidance that is neutral between classification of a worker as an employee or as an independent contractor, thus recognizing that many workers are, in fact, not employees. The guidance is also to include narrowly defined safe harbors or rebuttable presumptions, and a substantial portion of the guidance is to be industry or job specific. These guidelines recognize the need to prevent any particular service recipient from having a competitive advantage or disadvantage.

As noted above, some argue that there is a serious question whether it is possible to provide guidance that is simple, clear, and easy to understand in the context of the common-law facts-and-circumstances test. Some argue that guidance that provides very specific lines between employee and independent contractor status also may provide a road map for service recipients to structure the appearance of their relationship with workers as satisfying the standard in the guidance for classification of the worker as an independent contractor. This may occur even though, based on the actual facts and circumstances, the relationship is best characterized as that of an employee and employer.

Retention of a safe harbor for reasonable determinations by service recipient

Supporters of section 530 argue that a safe harbor is needed which continues to protect a service recipient's reasonable classification of workers as independent contractors in order to give businesses some certainty that their classifications will not be second guessed by the IRS. Supporters argue that retention of the current safe harbor for industry practice is needed to allow businesses within the same industry to classify workers and make legal arrangements in a manner consistent with their competitors. They argue that being permitted to follow industry

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[1282] The IRS has made publicly available its training guide for agents on worker classification issues. Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I. The guide may aid consistent enforcement by different agents and provide a guide to taxpayers regarding the state of the law; however, the guidelines leave substantial discretion to individual agents and do not resolve all issues. Further, the guidelines do not carry the same force of law as revenue rulings or regulations.

practice prevents a business from being forced to choose between following the industry practice, or making an independent judgment and being put at a competitive disadvantage.

Opponents of section 530 point out that, although section 530 was intended to reduce disputes between the IRS and taxpayers regarding classification issues, it has itself been a source of disputes. Like the common-law test, some aspects of section 530 depend on the facts and circumstances and reasonable people may differ as to the correct result given a certain set of facts, i.e., whether section 530 properly is available to the taxpayer. Those in favor of curtailing section 530 relief also point out that following industry practice is not a recognized legal standard for interpreting the law, and therefore should not be a reasonable basis for a legal determination. They argue that allowing use of industry practice as a defense or safe harbor simply encourages entire industries to continue to misclassify workers.[1283] They further argue that the industry practice safe harbor puts employers who chose not to rely on the safe harbor at a competitive disadvantage. Eliminating the industry-practice safe harbor would require service recipients to make the determination as to worker classification under the same legal standards as apply for other legal determinations under common law. A separate issue may be whether a reasonable determination that a worker is an independent contractor based on the application of recognized legal standards, such as judicial precedents, should be retained as a safe harbor.

Another criticism of section 530 is that it applies only to the service recipient and only for employment tax purposes. As a result of these limitations, if a worker is treated by the service recipient as an independent contractor under section 530, the worker may mistakenly believe he or she is in fact an independent contractor for Federal income tax purposes. However, because section 530 does not apply for Federal income tax purposes, the worker is still required to determine whether he or she is an independent contractor or employee under the common-law test without regard to section 530.

Proponents of curtailing section 530 relief argue that elimination of the safe harbor allows consistent classification by the worker and the service recipient. It would also eliminate a major barrier for workers to obtain the protection of being classified as an employee under other areas of law, both under the Code and other Federal and State laws, such as unemployment insurance and worker's compensation. Although section 530 is only a safe harbor for employment taxes, employers generally classify workers in the same manner for all purposes. Proponents of curtailing section 530 relief argue that, if an employee is classified as an independent contractor for employment tax purposes and section 530 protects the service recipient from reclassification of the worker for employment taxes, it is difficult for the IRS, other Federal agencies, and employees to challenge classifications for purposes outside the

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[1283] Marc Linder, "Employed or Self-employed? The Role and Content of the Legal Distinction: Dependent and Independent Contractors in Recent U.S. Labor Law: an Ambiguous Dichotomy Rooted in Simulated Statutory Purposelessness," 21 *Comparative Labor Law and Policy Journal* 187 (Fall 1999), p. 214 (characterizing the industry practice safe harbor as facilitating "the very race to the bottom that compulsory labor-protective laws are designed to thwart").

context of employment taxes.[1284] A worker may not understand that he or she is an employee for purposes of other Federal law, such as the FLSA, or may feel powerless to assert such right.[1285]

Prospective versus retroactive application of reclassification determinations

In general

The proposal provides a transition period for service recipients eligible to rely on section 530 under present law to voluntarily reclassify workers by specifying that prospective reclassification is not required until the first calendar year beginning at least one year after date of enactment. Some point out that the common-law test is a subjective facts and circumstances standard, and then argue that, if the employer has a reasonable basis for concluding that workers are independent contractors, any liability resulting from a different determination by the IRS should only be prospective. They argue that this was the original reason for the enactment of section 530, to prevent the IRS from second guessing an employer and imposing penalties for the past. Others argue that this just encourages employers to "hide in the weeds" and hope that they are not identified through an audit. They point out that the economic benefit to businesses to take this position creates a significant motivation for a business to misclassify employees as independent contractors. Further, as time goes on, a business may develop a vested interest in retaining this characterization and may be less willing to concede to an IRS determination that the worker is an employee on audit.

Others contend that an appropriate compromise is to require prospective reclassification independent of a specific IRS determination that the workers in a business are employees, only after the IRS issues industry-specific guidance that applies to the employees of the business. This reduces the possibility of businesses that reclassify workers as employees being at a competitive disadvantage.

Some argue that, even after guidance is issued, employers who comply based on a reasonable interpretation of the guidance, or some higher standard such that the taxpayer's interpretation is more likely than not to be correct, should be protected against retroactive reclassification of their workers to the extent that the guidance leaves room for different interpretations of a set of facts and circumstances. Others argue that this approach encourages businesses to interpret the guidance with a bias toward allowing a worker to be classified as an independent contractor even when the business recognizes that the interpretation is not intended, and the taxpayer expects the IRS to reach a different conclusion. This makes any retroactive assessment on audit the equivalent of a penalty against which the taxpayer can make a "good cause" argument rather than a tax for which the taxpayer is liable. One response to those making

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[1284] For example, even though a service recipient's classification of a worker as an independent contractor may be protected under section 530 for purposes of employment taxes, that classification may not be correct for other tax purposes, such as liability for failure to offer health coverage to full-time employees under section 4980H, added by section 1513 of PPACA (effective for calendar years beginning after December 31, 2013).

[1285] Catherine K. Ruckelhaus, "Labor's Wage War," 35 *Fordham Law Journal* 373, footnote 63 (pointing out that fear of reprisal prevents complaints with respect to wage and hour law violations despite the FLSA prohibition against such reprisal).

this argument would be to allow a reduction in liability and penalties, such as under present-law section 3509, but not completely relieve the taxpayer of retroactive liability.

Waiver of penalties for certain service recipients with a small number of workers

Under the proposal, for service recipients with only a small number of employees and a small number of misclassified workers, even reduced penalties are permitted to be waived if the service recipient consistently filed Forms 1099 reporting all payments to all misclassified workers, and agreed to prospective reclassification of misclassified workers. Assuming that waiver of the penalties means waiver of retroactive liability, this is equivalent to applying reclassification only prospectively. Proponents of prospective-only reclassification argue that there is no reason to limit this relief to service recipients with a small number of workers. For the reasons discussed above, they argue that all service recipients need this relief.

Supporters of this special rule argue that small businesses are the least sophisticated service recipients and are unlikely to be able to obtain legal counsel for worker classification issues. Thus, they argue that the focus for this group should be to obtain prospective proper classification. Some may respond that a better approach would be for IRS to undertake special outreach to educate this group but that taxpayers should not be rewarded for noncompliance with the law.

Contracts specifying worker classification

In some cases, a worker and service recipient mutually agree to the classification of the worker as an independent contractor, either informally or in a written contract. They may mutually prefer to have the worker classified as an independent contractor, for tax and nontax reasons.[1286] For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. Workers may prefer independent contractor status because it gives them more control over their livelihood. To the extent workers express this preference, the service recipients may feel compelled to classify a worker as an independent contractor to retain the worker. On the other hand, a service recipient may wish to avoid administrative issues associated with withholding income and employment taxes, as well as liability under other Federal law. The payments agreed to between the parties may be negotiated to reflect the difference in responsibilities between classification as an employee or as an independent contractor.

Some argue that if the worker and service recipient contractually agree as to the classification and both act consistently with the contract, such contractually-agreed-to treatment should be given deference in any classification determination, particularly when the proper classification is not clear.[1287] They argue that, as long as either the worker pays SECA and

[1286] Kirsten Harrington, "Employment Taxes: What Can the Small Businessman Do?" 10 *Akron Tax Journal*, 61 (1993).

[1287] Even if contracts were given some deference in worker classification determinations, an important first step would be an examination of the contract to determine if it in fact describes a relationship that is consistent with a worker being classified as an independent contractor and the agreement is in fact mutual. Those arguing in favor

income taxes, or the employer pays FICA and income tax withholding, the IRS should be indifferent as to the classification. Proponents of this approach argue that problems arise when the worker and the service recipient are taking inconsistent positions so neither is paying the appropriate social security taxes. They argue that absent a legal right to such deference, the IRS may feel compelled to use its power to make an independent determination of the facts and circumstances, and apply retroactive liability and penalties if it reaches a different conclusion as to the proper classification. Arguably, because the determination is based on the facts and circumstances many of which require a subjective determination, an independent determination may not be any more reliable than the agreed-to classification. The proposal gives some recognition to this argument by providing a two-year transition period for existing contracts.

Others contend that contracts between the parties specifying how the worker is to be classified are irrelevant, and the actual behavior of the parties is the only relevant consideration. Tax receipts and the total combined tax liability of the worker and service recipient are not the same regardless of the classification. They argue that, even if the ultimate combined tax liability of the parties is not significantly affected by the classification, the IRS has an interest in classifying workers as employees whenever appropriate, to obtain the compliance benefits of mandatory withholding.[1288] The parties should not be able to contract away that obligation of the employer.

Further, opponents of giving deference to contracts argue that the bargaining power, and sophistication, of the parties is not equal in many, if not most, circumstances. They argue that, in many cases, workers may feel they have little choice but to agree to their classification as independent contractors. In reality, the agreement may not be mutual. Even if a worker freely agrees to the classification, these opponents point out that a service recipient is likely to have a better understanding of its economic reasons for wanting to misclassify workers as independent contractors than a worker has of the economic benefits of being classified as an employee or the cost of being classified as an independent contractor. Workers may lack the sophistication to fully understand the implications of being classified as an independent contractor and how much larger payments need to be to reflect the increased costs and potential liabilities from being an independent contractor rather than an employee.[1289] For example, in addition to avoiding employment tax responsibilities, the service recipient may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors. The service recipient may want to avoid liability for workmen's compensation and may want to prevent the workers from having a right to join a

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of giving deference to contracts generally presuppose that the worker freely agrees to the classification and the worker and service recipient have equal bargaining power. Some argue that service recipients frequently simply apply this classification without any clear basis for such treatment or opportunity for objection by the worker.

[1288] Mark Berger, "Rethinking the Legal Oversight of Benefits Program Exclusions," 33 *Rutgers Law Journal* 227, p. 240 (Winter 2002).

[1289] Todd D. Saveland, "Note: FedEx's New 'Employees': Their Disgruntled Independent Contractors," 36 *Transportation Law Journal* 95 (Spring 2009). The author points out that the contractual relationship starts out seeming like a win-win for both the worker and the service recipient but then when the parties do not live happily ever after, the worker files suit.

labor union. A worker may not be aware of these economic advantages to the service recipient or fully appreciate their implications until an event occurs that makes the worker aware of the rights lost, such as a workplace injury.

Consistent classification of workers for all purposes

As under present law, the proposal only applies for purposes of employment taxes and by implication for purposes of the Code. As indicated above, worker classification is relevant for purposes of numerous Federal laws and for State law purposes.

Some argue that the same definition of employee should apply for purposes of Federal tax law and Federal labor laws.[1290] As long as treatment under a law is dependent on an individual's status as an "employee," absent a consistent definition, workers are unlikely to be able to independently determine their status for each purpose in order to demand the protection accorded them under Federal labor laws. Proponents of consistent classification argue that workers are most likely to be aware of their status for purposes of employment taxes. They know whether payroll taxes are being withheld from their paycheck or not. Thus, proponents of a single definition of employee for Federal law argue that the IRS is in the best position to administer and enforce proper worker classification. They argue that Federal agencies should be required to coordinate their interpretations of the law and enforcement with IRS.

Others argue that there should not be one definition of employee but rather the definition should vary depending on the purpose for which the definition is being used under the law.[1291] They argue that definition should be customized to the specific purpose for which it is being used.

Alternatively, some argue that some rights should not be conditioned on classification as an employee.[1292] All workers of a particular type in a particular industry should have certain fundamental protections and rights, determined without regard to the worker's classification as employee or independent contractor. Others argue that a service recipient should have only limited responsibility for workers not under its control or for workers that the employer does not have even the right to control.

[1290] Sharon Dietrich, Maurice Emsellem, and Catherine Ruckelshaus, "Work Reform: The Other Side of Welfare Reform: Our policymakers must face the reality that failures of employment law policies are a major reason for welfare recipiency," 9 *Stanford Law and Policy Review* 53, p. 60 (Winter 1998).

[1291] Marc Linder, "Employed or self-employed? The Role and Content of the Legal Distinction: Dependent and Independent Contractors in Recent U.S. Labor Law: an Ambiguous Dichotomy Rooted in Simulated Statutory Purposelessness," 21 *Comparative Labor Law and Policy Journal* 187 (Fall 1999).

[1292] Some circuits of the Court of Appeals have interpreted Title VII of the Civil Rights Act as protecting independent contractors (without regard to any reclassification as an employee) in certain circumstances. See for example, *Gomez v. Alexian Brothers Hospital*, 698 F. 2d 1019 (9th Cir. 1983), and *Doe v. St Joseph's Hospital*, 788 F. 2d 411 (7th Cir. 1986). See also G.J. Stillson MacDonnell, "Independent Contractor Status under Federal Labor and Employment Laws," at 5.02[B] (discussing Court of Appeals cases that recognize Title VII as protecting employment opportunities of independent contractors and those cases that limit Title VII protection to employees).

Worker classification and the contingent work force

The Bureau of Labor Statistics ("BLS") provides the following description of contingent and alternative employment arrangements:

"Contingent workers are persons who do not expect their jobs to last or who reported that their jobs are temporary. They do not have an implicit or explicit contract for ongoing employment. Alternative employment arrangements include persons employed as independent contractors, on-call workers, temporary help agency workers, and workers provided by contract firms."[1293]

Treasury indicates that a substantial portion of its guidance will be industry specific. There is no indication that Treasury views any special rules or attention as needed for the contingent workforce, separate from a particular industry or job in which they are utilized.

Some argue that contingent workers have become second-class employees. Generally, their arrangement includes some characteristics suggesting independent contractor status, such as a short-term relationship and less than full time schedule or irregular hours. Businesses create jobs for contingent workers with the objective of providing different compensation packages and working conditions for these workers. They argue that this second-class status puts contingent workers in a weaker position to oppose misclassification. They also argue that contingent workers are likely to be workers with few other employment opportunities. They point out that vulnerable employees, wrongly classified as independent contractors, may be unwilling to complain for fear of retaliation by their employer (regardless of the protection Federal law may accord the employee against such reprisal).

Some argue that an employer may be willing to give up control (or at least the semblance of control) to gain the advantage of treating contingent workers as independent contractors, and that employers may specifically design these jobs to avoid the appearance of having the requisite control to compel a classification of employee. Because the determination of employee status is inherently factual and includes subjective determinations, employers may be able to structure the arrangement with contingent workers so that it is more difficult to argue that a classification of a contingent worker as an independent contractor is improper. As noted above, there are strong financial incentives for an employer to classify workers as independent contractors whenever possible. They argue that the service recipients of contingent workers should be subject to greater scrutiny than service recipients of other independent contractors. They argue that Treasury should direct specific guidance toward the contingent work force as a special group apart from any specific industry in which they are performing services.

Others argue that contingent workers are no more vulnerable than other workers. They argue that many workers choose to be contingent workers and that the workers actually prefer their alternative work arrangements, including their status as independent contractors, to

[1293] Available at: http://www.bls.gov/cps/lfcharacteristics.htm#contingent.

traditional jobs.[1294] They argue that there should not be a bias in the law against classifying a worker as an independent contractor in an appropriately structured business relationship between the worker and service recipient. Thus, they would argue that the contingent work force should not be a specific target for published guidance.

Special rules in the proposal

Reduced penalties under section 3509

Under the proposal, current law relief under section 3509 would be limited to situations where a service recipient voluntarily reclassifies its workers before being contacted by the IRS. The relief under section 3509 is arguably unrelated to the curtailment of section 530 relief. Under present law, section 3509 only applies to a taxpayer that does not qualify for section 530 relief. Thus, even proponents of the curtailment of section 530 relief may argue that this proposed limitation on present law relief under section 3509 is beyond the scope of such a change. Critics of the curtailing section 530 relief argue that limiting the scope of section 3509 in conjunction with prospective curtailment of section 530 relief is likely to exacerbate the difficulties of this change. They argue that limiting the relief under section 3509 to those who have voluntary reclassified provides the relief to the wrong group. Those who have reclassified voluntarily presumably know that their classification was incorrect. Section 3509 is designed for taxpayers who are not entitled to protection under section 530 and unintentionally misclassify one or more employees as independent contractors.

Others argue that the reduced penalties under section 3509 are related to the relief under section 530. They argue that both provisions reduce compliance with proper worker classification. To the extent the risks from misclassification are reduced, service recipients feel comfortable erring on the side of classifying an employee as an independent contractor or at least "skating right up to the line" if the liability for misclassifying a worker as an independent contractor is reduced. They argue that the compliance structure should encourage service recipients to err on the side of classifying workers as employees. To the extent that there is any relief for misclassification, it should be for service recipients and workers when workers are misclassified as employees rather than as independent contractors.

[1294] Marisa DiNatale, "Characteristics of preferences for alternative work arrangements, 1999*" Monthly Labor Review* (March 2001), p. 28. The article describes the results of BLS 1999 Contingent and Alternative Work Arrangement Survey in which it found that one third of independent contractors in this category held a college degree and 12 percent held an advanced degree. The article points out that these proportions are slightly lower for traditional workers for the same time period which the article indicates is 31 percent college graduates and for which 10 percent held advanced degrees. The article also points out that compared with traditional workers, independent contractors at that time were more likely to be men, older, and white. The article indicates that, at least in 1999, the overwhelming majority of independent contractors were very happy in their arrangement and entered it voluntarily. Under the survey, about 84 percent of independent contractors reported that they preferred their arrangement to a traditional one in February 1999. A BLS News Release (USDL 05-1433), "Contingent and Alternative Employment Arrangements, February 2005," dated July 27, 2005, reports similar conclusions with respect to independent contractors in 2005.

Requiring service recipients to withhold income taxes upon request by independent contractors

Under the proposal, independent contractors receiving payments totaling $600 or more in a calendar year from a service recipient are permitted to require that the service recipient withhold for Federal tax purposes at a flat rate percentage of their gross payments, with the flat rate percentage selected by the contractor. Essentially, this proposal converts section 3402(p)(3) which, under present law, grants authority to the Secretary to provide for income tax withholding when both parties agree, into a provision that requires a service recipient to withhold income tax upon request by an independent contractor at the flat rate requested. Any independent contractor can make this request for any payment if the total payments during the year by the service recipient to independent contractor are $600 or more. The service recipient is compelled to comply. Some argue that this mandated withholding is inconsistent with a legitimate service recipient and independent contractor relationship. They argue that inherent in that relationship is that the independent contractor is responsible for paying his or her own estimated taxes. They argue that a taxpayer sophisticated enough to request income tax withholding is sophisticated enough to make estimated tax payments.

Prior Action

A similar proposal was included in the President's fiscal year 2011 budget proposal.

5. Repeal special estimated tax payment provision for insurance companies

Present Law

Income tax treatment of insurance companies

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. An insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[1295] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

A life insurance company is subject to tax on its life insurance company taxable income.[1296] Life insurance company taxable income is the sum of premiums and other consideration on insurance and annuity contracts, decreases in certain reserves, and other amounts includible in gross income, reduced by allowable deductions for all claims and benefits accrued and all losses incurred during the taxable year, increases in certain reserves, policyholder

[1295] Sec. 816.

[1296] Sec. 801.

dividends, dividends received, operations losses, certain reinsurance payments, and other deductions allowable for purposes of computing taxable income.[1297]

The taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[1298] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. Property and casualty insurance companies are required to discount unpaid loss reserves to take account partially of the time value of money.[1299]

Certain special rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[1300]

Special estimated tax payments under section 847

Allowance of additional deduction and establishment of special loss discount account

Present law allows an insurance company required to discount its reserves an additional deduction that is not to exceed the excess of (1) the amount of the undiscounted unpaid losses over (2) the amount of the related discounted unpaid losses, to the extent the amount was not deducted in a preceding taxable year. This provision imposes the requirement that a special loss discount account be established and maintained, and that special estimated tax payments be made. Unused amounts of special estimated tax payments are treated as a section 6655 estimated tax payment for the 16th year after the year for which the special estimated tax payment was made.[1301]

The total payments by a taxpayer, including section 6655 estimated tax payments and other tax payments, together with special estimated tax payments made under this provision, are generally the same as the total tax payments that the taxpayer would make if the taxpayer did not elect to have this provision apply, except to the extent amounts can be refunded under the provision in the 16th year.

[1297] Secs. 801-818.

[1298] Sec. 832.

[1299] Sec. 846.

[1300] Secs. 841-848.

[1301] Sec. 847.

Calculation of special estimated tax payments based on tax benefit attributable to deduction

More specifically, present law imposes a requirement that the taxpayer make special estimated tax payments in an amount equal to the tax benefit attributable to the additional deduction allowed under the provision. If amounts are included in gross income due to a reduction in the taxpayer's special loss discount account or due to the liquidation or termination of the taxpayer's insurance business, and an additional tax is due for any year as a result of the inclusion, then an amount of the special estimated tax payments equal to such additional tax is applied against such additional tax. If there is an adjustment reducing the amount of additional tax against which the special estimated tax payment was applied, then in lieu of any credit or refund for the reduction, a special estimated tax payment is treated as made in an amount equal to the amount that would otherwise be allowable as a credit or refund.

The amount of the tax benefit attributable to the deduction is to be determined (under Treasury regulations (which have not been promulgated)) by taking into account tax benefits that would arise from the carryback of any net operating loss for the year as well as current year benefits. In addition, tax benefits for the current and carryback years are to take into account the benefit of filing a consolidated return with another insurance company without regard to the consolidation limitations imposed by section 1503(c).

The taxpayer's estimated tax payments under section 6655 are to be determined without regard to the additional deduction allowed under this provision and the special estimated tax payments. Legislative history[1302] indicates that it is intended that the taxpayer may apply the amount of an overpayment of his section 6655 estimated tax payments for the taxable year against the amount of the special estimated tax payment required under this provision. The special estimated tax payments under this provision are not treated as estimated tax payments for purposes of section 6655 (e.g., for purposes of calculating penalties or interest on underpayments of estimated tax) when such special estimated tax payments are made.

Refundable amount

To the extent that a special estimated tax payment is not used to offset additional tax due for any of the first 15 taxable years beginning after the year for which the payment was made, such special estimated tax payment is treated as an estimated tax payment made under section 6655 for the 16th year after the year for which the special estimated tax payment was made. If the amount of such deemed section 6655 payment, together with the taxpayer's other payments credited against tax liability for such 16th year, exceeds the tax liability for such year, then the excess (up to the amount of the deemed section 6655 payment) may be refunded to the taxpayer to the same extent provided under present law with respect to overpayments of tax.

[1302] See H.R. Rep. No. 100-1104, Conference Report to accompany H.R. 4333, the Technical and Miscellaneous Revenue Act of 1988, October 21, 1988, p. 174.

Regulatory authority

In addition to the regulatory authority to adjust the amount of special estimated tax payments in the event of a change in the corporate tax rate, the provision provides authority to the Treasury Department to prescribe regulations necessary or appropriate to carry out the purposes of the provision.

Such regulations include those providing for the separate application of the provision with respect to each accident year. Separate application of the provision with respect to each accident year (i.e., applying a vintaging methodology) may be appropriate under regulations to determine the amount of tax liability for any taxable year against which special estimated tax payments are applied, and to determine the amount (if any) of special estimated tax payments remaining after the 15th year which may be available to be refunded to the taxpayer.

Regulatory authority is also provided to make such adjustments in the application of the provision as may be necessary to take into account the corporate alternative minimum tax. Under this regulatory authority, rules similar to those applicable in the case of a change in the corporate tax rate are intended to apply to determine the amount of special estimated tax payments that may be applied against tax calculated at the corporate alternative minimum tax rate. The special estimated tax payments are not treated as payments of regular tax for purposes of determining the taxpayer's alternative minimum tax liability.

Regulations have not been promulgated under section 847.

Description of Proposal

The proposal repeals the rules of section 847. Thus, the election to apply the provision, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules of present law are eliminated under the proposal.

The proposal provides for treatment of existing special loss discount accounts. The entire balance of an existing account is included in income of the taxpayer for the first taxable year beginning after 2011, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to this inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under section 6655.

Alternatively, the taxpayer may elect to include the entire balance of an existing account in income ratably over the first four taxable years beginning after 2011, and to apply existing special estimated tax payments against additional tax attributable to this inclusion. Any remaining special estimated tax payments are treated as estimated tax payments under section 6655.

Analysis

The proposal reflects a concern with the recordkeeping burden imposed under the special estimated tax provision, as well as the complexity introduced in the tax system by the interaction of the provision with other Federal income tax rules applicable to insurance companies. For example, the application of the provision becomes difficult when the taxpayer is subject to

regular tax and to alternative minimum tax in successive years. Similarly, the provision does not work well in the consolidated return context. Consolidated return limitations on losses of nonlife insurance company losses against life insurance company income create difficulties in the operation of the special estimated tax provision. It is argued that the special estimated tax provision is not needed for accurate income measurement under the Federal income tax rules, and that the additional complexity for the government and for taxpayers is not merited on the basis of any benefit either to the government or to taxpayers under the tax system. Thus, it is asserted, the provision should be repealed.

It could be argued, however, that the special estimated tax provision was not intended to improve income measurement under the Federal tax rules. The assertions that the provision does not improve accurate income measurement, and that the provision adds complexity to the administration of the tax law, ignore the original purpose of the provision to provide a book accounting benefit to insurers. The special estimated tax provision was designed and added to the law in 1988, two years after property and casualty insurers had become subject to discounting rules taking account partially of the time value of money in calculating the Federal income tax deduction for loss reserves. The special estimated tax provision was intended to allow the companies to separately identify their tax liability attributable to the reserve discounting rules, and ultimately to treat this separately identified item as an asset on the financial statement of the company.[1303] Even though financial accounting rules did not identify this item as an asset for book purposes at the time, it may have been anticipated that the addition to the tax law of the special estimated tax provision would facilitate this accounting treatment. Therefore, though the provision adds marginal complexity to the tax law, it can be argued that the complexity may be merited because appropriate accounting treatment is permitted by identifying the tax reserve discounting amount in this manner.

However, the financial accounting rules have not and do not currently provide for this accounting treatment. Consequently, if the rationale for the provision is the nontax policy purpose to provide an accounting benefit, that purpose has not been satisfied, nor can it be satisfied by further tax legislation.

A related point is that the addition to the tax law of a provision aimed at clarifying book accounting treatment may not be an appropriate use of the tax law. In its purest form, an income tax should accurately measure the income of each taxpayer without needless complexity and should treat similarly situated taxpayers similarly: the principle of tax neutrality. The addition to the tax law of a provision whose sole purpose is to persuade the arbiters of book accounting treatment to allow an item to be treated as an asset on companies' financial statements arguably impairs the efficiency of the tax law and subverts income tax policy. Thus, such a provision

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[1303] In its reasons for change with respect to the earliest legislative version of the provision, the Ways and Means Committee stated, "Property and casualty insurance companies should be allowed to identify separately their tax liability attributable to the 1986 Act discounting rules, even though under currently applicable financial reporting principles this treatment does not create an asset that is reflected on the financial statement of a property and casualty insurance company." H. Rep. No. 100-795, Report of the Committee on Ways and Means of the House of Representatives to accompany the "Miscellaneous Revenue Act of 1998," 100th Cong, 2d Sess., July 26, 1988, p. 547.

should be excised from the tax law. This argument is strengthened by the failure of the provision to give rise to the desired financial statement treatment under both past and current accounting practice. Thus, there is no defensible basis on which to retain the special estimated tax provision, it is argued.

Advocates of repealing the provision also point to its anomalous effect on State income tax liability for taxpayers in States with a taxable income calculation that piggybacks on the taxpayer's Federal income tax calculation. In this context, the mechanical result of the provision may be that, for State law purposes, if the taxpayer elects section 847 treatment for Federal tax purposes, the section 847 additional deduction is allowed for State purposes, but a special estimated State tax payment is not made, a lack of parallelism that operates to the detriment of such States. On the other hand, such States could remedy this detriment by legislating a specific change to the State tax rules.

In repealing the special estimated tax provision, the proposal provides for a one year inclusion of amounts in taxpayers' existing special loss discount accounts (if any), offset by existing special estimated tax payments. The proposal also provides an elective four-year period for inclusion (and offset). The four-year inclusion and offset period is analogous to a rule of present law, section 481, that provides (under Treasury regulations) generally for a four-year spread of a negative adjustment that arises upon a taxpayer's change in method of accounting for tax purposes.[1304] The four-year spread of the section 481 adjustment is not explicitly elective, however.

Because taxpayer elections generally permit adverse selection against the government, and because one of the stated concerns regarding the present-law provision relates to the recordkeeping burden, a single nonelective short period over which the accounts are included in income may arguably be more consistent with the rationale for repeal. A nonelective short period eliminates the adverse selection concern, and shortens the period for which recordkeeping burdens remain in place. On the other hand, particular tax attributes of each taxpayer may impact the timing or manner in which the special loss discount account inclusion is taxed under the provision. Allowing an elective four-year period for inclusion could address potential disparate impact among taxpayers of the repeal. Further, taxpayer convenience and the principle of fairness may suggest that a taxpayer election is preferable to a mandatory period, and that a longer spread period analogous to the four-year period of section 481 eases transition to repeal more effectively.

Prior Action

No prior action.

[1304] Sec. 481(a), Treas. Reg. sec. 1.481-1, and Rev. Procs. 2007-67 (2007-2 C.B. 1072), 2002-19 (2002-1 C.B. 696), and 97-27 (1997-1 C.B. 680).

6. Eliminate special rules modifying the amount of estimated tax payments by corporations

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.[1305] For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15. For fiscal year taxpayers, these payments would be made by the 15th day of the fourth, sixth, ninth and twelfth month of the fiscal year. In the case of a corporation with assets of at least $1 billion ("large corporations") (determined as of the end of the preceding taxable year):

(i) payments due in July, August, or September, 2014, are increased to 174.25 percent of the payment otherwise due;[1306]

(ii) payments due in July, August, or September, 2015, are increased to 163.75 percent of the payment otherwise due;1307 and

(iii) payments due in July, August, or September, 2019, are increased to 106.50 percent of the payment otherwise due.[1308]

For each of the periods impacted, the next required payment is reduced accordingly.

Description of Proposal

The proposal repeals all legislative acts that cause the amount and timing of corporate estimated payments to differ from the rules described under section 6655.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2011.

[1305] Sec. 6655.

[1306] Haiti Economic Lift Program of 2010, Pub. L. No. 111-171, sec. 12(a); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, sec. 1410; Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 561, (1); Act to extend the Generalized System of Preferences and the Andean Trade Preference Act, and for other purposes, Pub. L. No. 111-124, sec. 4; Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, sec. 18; Joint resolution approving the renewal of import restrictions contained in the Burmese Freedom and Democracy Act of 2003, and for other purposes, Pub. L. No. 111-42, sec. 202(b)(1).

[1307] Omnibus Trade Act of 2010, Pub. L. No. 111-344, sec. 10002; Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2131; Firearms Excise Tax Improvements Act of 2010, Pub. L. No. 111-237, sec. 4(a); United States Manufacturing Enhancement Act of 2010, Pub. L. No. 111-227, sec. 4002; Joint resolution approving the renewal of import restrictions contained in the Burmese Freedom and Democracy Act of 2003, and for other purposes, No. 111-210, sec. 3; Haiti Economic Lift Program of 2010, Pub. L. No. 111-171, sec. 12(b); Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 561, (2).

[1308] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 561, (3).

Analysis

Under the budgetary "pay-as-you-go" rules in the House and the Senate as well as the statutory Pay-As-You-Go Act of 2010 (collectively "PAYGO rules"),[1309] there is generally a prohibition on the consideration of revenue or direct spending legislation that would cause (or increase) an on-budget deficit over a five-year rolling budget window or the 10-year rolling budget window. When these restrictions apply, revenue reductions, direct spending increases, or a combination of the two are allowed only so long as they are completely offset by revenue increases, spending decreases, or both.

Under section 6655, corporations generally are required to pay their income tax liability for a taxable year in quarterly estimated payments. These modifications help to ensure that certain pieces of legislation do not cause (or increase) an on-budget deficit during the first five fiscal years covered by the budget resolution and thus fully comply with the various PAYGO rules. A number of legislative acts have modified the standard requirement as to the amount due by large corporations for a particular quarter by increasing the amount of estimated tax payments otherwise due in July, August or September of an applicable period by an amount in excess of 100 percent of the amount otherwise due. There is then a corresponding decrease in estimated tax payments in the next required payment. Because the Federal budget is on a fiscal year that ends each year on September 30th, the shift forward of corporate estimated tax payments generally occurs with respect to payments that would otherwise be made in the first quarter of year six of the 10-year budget window into year five, which is in both the five-year and 10-year rolling budget windows. The net effect of the acceleration of these estimated tax payments is the generation of additional revenue in the five-year budget window without any additional revenue being created in the 10-year budget window.[1310]

It may be argued that the frequent changes to the corporate estimated tax payment schedule do not generally increase a corporation's income tax liability for a particular taxable year; nonetheless, the frequency of such changes increases uncertainty within the corporate tax system.[1311] Furthermore, to the extent corporations are ultimately required to make estimated tax payments to the government in excess of 100 percent of the amount otherwise due, this is the economic equivalent of requiring these corporations to make interest free loans to the Federal government. Arguably, the money used to make these larger than normal payments could be deployed by these corporations into more productive investments. Since the proposal would repeal the previous modifications to the amount and timing of corporate estimated tax payments under section 6655, it may help to decrease some of this uncertainty.

[1309] Pub. L. No. 111-139; Robert Keith, *The Statutory Pay-As-You Go Act of 2010: Summary and Legislative History*, CRS Report R41510, April 2, 2010.

[1310] Eric S. Kroh and Amy S. Elliot, "On Tax, Obama Budget Tweaks Some Old Standards," 130 *Tax Notes* 865 (February 21, 2011). In order to comply with House, Senate and statutory budgetary rules generally requiring that bill a resulting in a spending increase be offset with corresponding tax increase or spending decrease so that there is no net outflow in either the 5-year or 10-year budget window.

[1311] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, p. 110.

Others may argue that, to the extent these modifications were originally enacted to comply with the five-year rolling budget window requirement under PAYGO, a subsequent repeal of the provision would be contrary to the purpose and intent of PAYGO even though technically not a violation.

Prior Action

No prior action.

C. Strengthen Tax Administration

1. Revise offer-in-compromise application rules

Present Law

The IRS is authorized to enter into offers-in-compromise under which the taxpayer and Federal government agree that a tax liability may be satisfied by payment of less than the full amount owed.[1312] An offer-in-compromise may be accepted on one of three grounds: (1) doubt as to liability, available in cases in which the validity of the actual tax liability is in question, (2) doubt as to collectability based on lack of sufficient assets from which the tax, interest, and penalties can be paid in full, or (3) effective tax administration, applicable in a case in which collection in full would cause the taxpayer economic hardship such that compromise rather than collection would better encourage tax compliance.[1313] According to Policy Statement 5-100,[1314] the goal is to collect as much as is potentially collectible of a delinquent tax debt at the earliest time and at the least cost to the government. An offer-in-compromise is viewed as an alternative to declaring the tax debt uncollectible or collectible only under protracted proceedings. If the unpaid tax liabilities total $50,000 or more, an offer-in-compromise can be accepted only if a public report is filed, supported by a written opinion from the IRS Chief Counsel, stating the reasons for the compromise, the amounts of assessed tax, penalties and interest and the amounts actually paid pursuant to the offer-in-compromise.[1315]

The Tax Increase Prevention Reconciliation Act of 2005 ("TIPRA") included a provision requiring taxpayers to make certain nonrefundable payments with any initial offer-in-compromise of a tax case.[1316] Taxpayers making a lump sum offer-in-compromise must include a nonrefundable payment of 20 percent of the lump sum with the initial offer.[1317] Taxpayers seeking an offer-in-compromise involving periodic payments must provide a nonrefundable payment of the first installment that would be due if the offer were accepted.[1318]

Description of Proposal

The proposal eliminates the requirement that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer.

[1312] Sec. 7122.

[1313] Treas. Reg. sec. 1.7122-1(b). For this purpose, economic hardship is defined under Treas. Reg. sec. 301.6343-1.

[1314] Policy Statement 5-100 (January 30, 1992), IRM 1.2.14.1.17.

[1315] Sec. 7122(b); Treas. Reg. sec. 1.7122-1(e)(6). The $50,000 threshold was raised from $500 in 1996. Sec. 503 of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168.

[1316] Sec. 509(a) of TIPRA, Pub. L. No. 109-222.

[1317] Sec. 7122(c)(1)(A).

[1318] Sec. 7122(c)(1)(B).

Effective date.−The proposal is effective for offers-in-compromise submitted after the date of enactment.

Analysis

The IRS has been criticized for its conduct of the offer-in-compromise program based on its perceived reluctance to exercise the settlement authority provided by law. The criticism led to legislation that expanded the procedural protections available to taxpayers facing collection action by the IRS and mandated regulatory changes.[1319] These changes included establishment of new guidelines for review of offers, allowances for basic living expenses, special rules on treating offers from low-income taxpayers, and rules for processing offers based on doubt as to liability. These changes were intended to ensure that the authority to compromise tax debts was exercised as often as appropriate. The program is designed to settle cases in which taxpayers have demonstrated an inability to pay the full amount of a tax liability by allowing the IRS the flexibility to consider a tax liability to be paid in full upon collection of the portion of the debt determined to be acceptable under an offer-in-compromise. Reducing access to the offer-in-compromise program arguably makes it more difficult and costly to obtain the collectable portion of existing tax liabilities.

Even if repeal of the down payment requirement prompts submission of a greater number of offers, a commensurate surge in acceptances might not result. Although awareness of the program was heightened, and applications for offers in compromise reached a peak of 128,000 offers in FY2003, the number of offers accepted has remained relatively constant.[1320] Since 2003, applications have dropped sharply, a drop accompanied with a less pronounced decline in accepted offers. In 2009 and 2010, the number of offers began to rise slowly, although the amount recovered from acceptance of offers continued to decline.[1321] As a result, the program remains vulnerable to the criticism that it is underutilized, as argued by the National Taxpayer Advocate for the past nine years.[1322] Repeal of the down payment requirement may lead to an increase in the number of applications, as its proponents contend, but does not address the more general question of how the IRS exercises its authority.

When enactment of the down payment requirement was under consideration in 2006, some predicted that requiring nonrefundable payments with an offer-in-compromise would substantially reduce participation in the offer-in-compromise program.[1323] According to those

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[1319] See, e.g., "The Revenue Restructuring Act of 1998," Pub. L. No. 105-206, sec. 3462 (amended Code sec. 7122) and Pub. L. No. 100-647, sec. 6236(a)(3) (amended Code section 6331 to require that information on availability of alternative payment methods, such as installment agreements, be included in notice of intent to levy on property).

[1320] IRS 2009 Data Book, Table 16b, available at <http://www.irs.gov/pub/irs-soi/09db16bcoe.xls>

[1321] IRS 2010 Data Book, Table 16.

[1322] 2010 Annual Report to Congress, page 311, provides a summary of past criticism of the program and a status update on how the IRS has responded administratively to the criticism.

[1323] See, e.g., Dennis B. Drapkin, Testimony on behalf of the ABA before the Subcommittee on Oversight, House Committee on Ways and Means, U.S. House of Representatives, April 6, 2006, available at

who support the Administration proposal, the fears expressed earlier have been realized. In her annual report to Congress for 2008, the National Taxpayer Advocate opined that the drop in the number of applications for offers-in-compromise was attributable to the required nonrefundable down payment, as had been predicted. In support, she noted the low acceptance rate of offers and the fact that funds for many offers are provided by family members and friends. She concluded that friends and family would not provide the funds to pay the compromised tax debts because "they are likely to forfeit 20 percent of the offered amount without compromising the liability."[1324]

That opinion is based on an informal study of case files for 414 offers-in-compromise accepted by the IRS in the months prior to the TIPRA effective date. National Taxpayer Advocate staff reviewed the closed case files to determine whether the taxpayer could have made a down payment of the amount required by TIPRA on the actual offer submitted and accepted by IRS had that requirement been in effect, and to determine the source of funds used to make the payments required under the terms of the compromise accepted.[1325] Based on the information from the case files, National Taxpayer Advocate concluded that adequate funds for a down payment would not have been available from the liquid assets (cash, bank accounts, CDs, stock and securities) in 70 percent of the cases. National Taxpayer Advocate further noted that family and friends were the source of the funds for 232, or 56 percent, of the offers.

Alternative explanations for the decline in the number of offers submitted must be considered, because the number of offers was already declining prior to the nonrefundable deposit requirement enacted by TIPRA. From information in the IRS Data Book, it appears that offers decreased from FY 1997 through FY 1999, increased from FY 1999 through FY 2003, and declined sharply until 2009.[1326] One explanation for the decline in offers is that the substantial increase in personal wealth during FY 2004 through FY 2008 resulting from increased housing values, stock portfolios, and retirement plan investments suppressed the number of taxpayers meeting the offer-in-compromise requirements. Another possible explanation is that the low

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http://www.abanet.org/tax/pubpolicy/2006/060406testimony.pdf, noting that "A successful offer-in-compromise program raises revenue both from the offer and by bringing taxpayers back into the system. Relatives and employers of the taxpayer are often the source of funds for offers in the current system. These parties will understandably be far less willing to commit nonrefundable monies under the regime that would be created by the Senate bill. Because the 20-percent nonrefundable down payment requirement could dramatically reduce available outside funding for potential offers, there is a significant risk that the proposal could decrease the number of legitimate offers submitted, the number of offers accepted and the number of individuals reentering the tax system. The provision also marks a change in direction from the 1998 Taxpayer Bill of Rights."

[1324] 2007 National Taxpayer Advocate report at Volume 2, section 3, "Effect of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program." The National Taxpayer Advocate has renewed her call for repeal in her annual legislative recommendations for 2010. 2009 National Taxpayer Advocate Report to Congress, Volume 1, pp. 203-204.

[1325] See Nina E. Olson, National Taxpayer Advocate, Written Statement of Testimony before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Hearing on Tax Compliance Challenges Facing Financially Struggling Taxpayers, February 26, 2009, available at http://waysandmeans.house.gov/media/pdf/111/olson.pdf.

[1326] IRS 2008 Data Book, available at http://www.irs.gov/pub/irs-soi/08databk.pdf.

acceptance rate discouraged participation. When the required guidelines on allowable living expenses and the computation of reasonable collection potential were published, taxpayers may have concluded that they would not meet the criteria for participation. If any of these factors caused the drop in offers, opponents of repeal of the deposit may argue that the payment requirement may not have a significant effect on the use of the offer-in-compromise program.

Prior Action

A similar proposal was included in the President's fiscal years 2010 and 2011 budget proposals.[1327]

2. Expand IRS access to information in the National Directory of New Hires for tax administration purposes

Present Law

The Office of Child Support Enforcement of the Department of Health and Human Services ("HHS") maintains the National Directory of New Hires ("the Directory"), which is a database that contains newly-hired employee data from Form W-4, quarterly wage data from State and Federal employment security agencies, and unemployment benefit data from State unemployment insurance agencies. The Directory was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Under the Social Security Act, the IRS may obtain data from the Directory only for the purpose of administering the earned income tax credit ("EITC") and verifying a taxpayer's employment that is reported on a tax return.[1328] The IRS may also negotiate for access to employment data directly from State agencies responsible for such data, to the extent permitted by the laws of the various States. Generally, the IRS obtains such employment data less frequently than quarterly, due to the significant internal costs it incurs in preparing these data for use.

Description of Proposal

The proposal amends the Social Security Act to expand IRS access to Directory data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for noncompliant taxpayers, and identification of levy sources. The proposal provides that data obtained by the IRS from the Directory is protected by existing taxpayer privacy law, including civil and criminal sanctions.

Effective date.–The proposal is effective upon enactment.

[1327] H.R. 2343, *The Tax Compromise Improvement Act of 2009*, was introduced in the House of Representatives on May 12, 2009. This bill would eliminate the requirement for taxpayers to pay a percentage of the proposed offer-in-compromise as a mandatory, nonrefundable part of their application.

[1328] Sec. 32(a)(1).

Analysis

The proposal is expected to enhance tax administration by providing the IRS with a more efficient method to obtain taxpayer data and verify taxpayer claims. Obtaining taxpayer data from the Directory rather than relying on availability from separate State agencies may promote greater consistency in enforcement and enhance productivity of the IRS by reducing the resources it must dedicate to obtaining and processing such data. Because any data obtained by the IRS from the Directory is protected by existing disclosure law, proponents argue that the proposal does not reduce the current levels of taxpayer privacy.

Opponents may argue that expansion of IRS access to the database is an infringement of individual privacy. When first created, the database was intended to provide State child support enforcement agencies a centralized source of information for locating noncustodial parents without requiring contact with each State. Although opponents may agree that IRS access for EITC purposes may be consistent with the policy underlying the creation of the database, they argue that IRS access for general tax administration purposes is not.

Prior Action

The proposal was included in the President's fiscal year 2006, 2007, 2008, 2009, 2010 and 2011 budget proposals.

3. Make repeated willful failure to file a tax return a felony

Present Law

Under present law, the willful failure to file a return, pay taxes, keep records, or supply any information required by the Code is a misdemeanor punishable by a term of imprisonment of not more than one year, a fine up to $100,000, or both.[1329] In the case of a corporation, the monetary penalty is increased to a maximum of $200,000. A taxpayer who fails to file returns for multiple years commits a separate misdemeanor offense for each year. The elements of a willful failure to file require that the government prove beyond a reasonable doubt that (1) the defendant was a person required to file a return; (2) the defendant failed to file at the time required by law, and (3) the failure was willful. The government need not prove that there is an unpaid tax, only that the taxpayer had sufficient income to be required to file a return.[1330]

In contrast, willful tax evasion and willful failure to file in connection with a violation of section 6050I (requiring disclosure of certain cash transactions) are felonies, punishable by a prison sentence of up to five years and a fine of up to $100,000 for an individual ($500,000 in

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[1329] Although section 7203 refers to maximum fines of only $25,000 for individuals and $100,000 against organizations, the authority of district courts to impose criminal fines is provided in Title 18 of the United States Code, which authorizes a fine of up to $100,000 against an individual convicted of a class A misdemeanor, and $200,000 for an organization convicted of same. 18 U.S.C. secs. 3551 and 3571.

[1330] *Spies v. United States*, 317 U.S. 492, 496 (1943).

the case of a corporation).[1331] Conviction of tax evasion requires that the government prove beyond a reasonable doubt that an affirmative act constituting an attempt to evade or defeat a tax or the payment thereof occurred,[1332] that there is an additional tax due and owing,[1333] and willfulness.[1334]

The punishment of willful tax evasion as a felony rather than a misdemeanor carries with it collateral consequences, in that a person convicted of a felony is deprived of a number of civil and social rights in most States and under Federal law.[1335] Federal immigration law generally requires deportation of aliens who are convicted of felonies.[1336] Many States bar felons from voting, owning firearms, and securing a professional license.[1337]

Description of Proposal

Under the proposal, any person who willfully fails to file tax returns in any three years within any five consecutive year period, if the aggregated tax liability for such period is at least $50,000, is subject to a new aggravated failure to file criminal penalty. The proposal classifies such failure as a felony and, upon conviction, imposes a fine of not more than $250,000 ($500,000 in the case of a corporation) or imprisonment for not more than five years, or both.

Effective date.−The proposal is effective for returns required to be filed after December 31, 2011.

Analysis

The Administration states that "Increased criminal penalties would help to deter multiple willful failures to file tax returns." Deterrence is a well-accepted rationale for imposition of penalties. Proponents contend that the return filing obligation is of paramount importance to the tax system. Accordingly, a repeated pattern of intentionally failing to file poses a threat to the system sufficiently serious to warrant the creation of a separate felony crime. Proponents contend that the substantially increased potential sentences together with the long-term repercussions associated with a felony record would deter recidivist failure to file.

[1331] See, secs. 7201 and 7203 (last sentence). Although section 7201 refers to a fine against an individual of only $100,000. Title 18 authorizes a Federal court to impose a fine of up to $250,000 against an individual convicted of a felony. 18 U.S.C. secs. 3551, 3571.

[1332] *Sansone v. United States*, 380 U.S. 343, 351 (1965); *Spies v. United States*, 317 U.S. 492, 497-99 (1943).

[1333] *Boulware v. United States*, 522 U.S. 421 (2008); *Sansone v. United States*, 380 U.S. 343, 351 (1965).

[1334] *Cheek v. United States*, 498 U.S. 192, 193 (1991).

[1335] 21 U.S.C. sec. 862(a)(1)(A), (B) (1999) denies certain benefits to those convicted of drug offenses.

[1336] 8 U.S.C. sec. 1227(a)(2). See also, 8 U.S.C. sec. 1101(a)(43)(M)(ii).

[1337] See, e.g., N.Y. Elec. Law sec. 5-106(2), Wyo. Stat. 6-8-102, and ARS sec. 32-741(A) (Arizona).

On the other hand, the proposal may increase complexity without improving compliance because present law already provides enhanced criminal penalties in certain circumstances. For example, when failure to file a tax return is accompanied the intent to evade taxes, a felony prosecution is possible under present law. To the extent that recidivism is established, sentencing guidelines permit enhanced penalties. Without additional empirical information, it is not obvious that existing criminal tax penalties do not already adequately deter criminal behavior, but that increased penalties would. Generally, an increase in the expected costs of noncompliant behavior, such as increased penalties or increased audit rates, can be expected to decrease the amount of noncompliance. It may be more effective to increase the monetary civil penalties for failing to file a tax return, thus increasing the economic risk of such failure, provided that the likelihood of detection does not decrease.

In addition, the fact that there are long-term repercussions associated with a felony may have unintended consequences. For example, the government may exercise its discretion to assert such a penalty in fewer cases than if the offense were classified as a misdemeanor. If a penalty is not applied in practice or is perceived as not likely to be applied in practice, the deterrent effects of the penalty are not realized and trust in government may be eroded. One may note that criminal prosecutions are infrequent. According to the most recent IRS data, the total number of all criminal prosecutions for tax offenses in one year was 2,645, resulting in 2,184 convictions. Of those convicted, 81 percent were incarcerated.[1338] Finally, to the extent the imposition of a criminal penalty results in significant increases in sentences to prison, the government incurs additional costs of incarceration.

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009, 2010 and 2011 budget proposals.

4. Facilitate tax compliance with local jurisdictions

Present Law

Generally, tax returns and return information ("tax information") are confidential and may not be disclosed unless authorized in the Code. One exception to the general rule of confidentiality is the disclosure of tax information to the States.

Certain Federal tax information is open to inspection by State agencies, bodies, commissions, or legal representatives, charged under the laws of the State with tax administration responsibilities.[1339] Such inspection is permitted only to the extent necessary for State tax administration proposes. The Code requires a written request from the head of the agency, body or commission as a prerequisite for disclosure. State officials who receive this

[1338] IRS 2010 Databook, Table 18. "Incarcerated" includes confinement in prison, electronic monitoring, home arrest or a combination of the three.

[1339] Sec. 6103(d)(1).

information may redisclose it to the agency's contractors but only for State tax administration purposes.[1340]

For purposes of authorizing disclosure of tax information, the term "State" includes the 50 States, the District of Columbia, and certain territories.[1341] In addition, cities with populations in excess of 250,000 that impose a tax on income or wages and with which the IRS has entered into an agreement regarding disclosure also are treated as States.[1342]

Indian tribal governments are separately defined as the governing bodies of any tribe, band, community, village or group of Indians, and in certain instances, Alaska Natives, that exercise governmental functions as determined by the Secretary in consultation with the Secretary of Interior.[1343] They are not currently within the scope of those authorized to receive tax information as State or local authorities. However, Indian tribal governments are already treated as States by the tax law for several other purposes, such as certain charitable contributions, excise tax credits, and local tax deductions, but not for purposes of information sharing.[1344]

Description of Proposal

Under the proposal, Indian tribal governments that impose alcohol, tobacco, or fuel excise or income or wage taxes are treated as States for purposes of information sharing to the extent necessary for Indian tribal government tax administration. The proposal requires an Indian tribal government that receives Federal tax information to safeguard it according to prescribed protocols, which impose criminal and civil sanctions on violations.

Effective date.–The proposal is effective for disclosures made after the date of enactment.

Analysis

Many States use Federal tax concepts as the starting point for their own returns. As a result, those States are dependent on Federal tax information to ensure compliance with their own State tax system. In addition, cooperation between the IRS and State governments is thought to improve voluntary compliance. The IRS has recently embarked on a program to obtain more information from the States to assist with Federal tax compliance.

[1340] Sec. 6103(n).

[1341] Sec. 6103(b)(5)(A). In contrast, the term State is generally defined by section 7701(a)(10) to include only the states and the District of Columbia. Neither definition includes Indian tribal governments.

[1342] Sec. 6103(b)(5)(B).

[1343] Sec. 7701(a)(40).

[1344] Sec. 7871.

The proposal expands the definition of a State to include an Indian tribal government for purposes of disclosing tax information. Proponents of the proposal may argue that providing tax information to an Indian tribal government may assist such tribe with the enforcement of tribal tax laws. The sharing of information with Indian tribal governments also may encourage the tribes to share information with the IRS that may be helpful for Federal enforcement efforts.

Unlike the rule for a city to be treated as a State, generally requiring a population of 250,000 or more, the proposal sets no minimum population requirement for an Indian tribe to be treated as a State. Thus, some may argue that the privacy rights of taxpayers are more likely to be compromised if the population of taxpayers whose information is subject to disclosure is very small. One also could argue that the benefit to Federal tax compliance would decline as the size of the population diminishes. In addition, Federal tax data is subject to stringent physical and computer security restrictions, which may be costly and burdensome for a small tribal government to implement. This line of reasoning suggests that a population threshold like that applicable to a city treatable as a State is equally justified for an Indian tribe.

Prior Action

A similar proposal was included in the President's budget for fiscal years 2009, 2010 and 2011.

5. Extension of statute of limitations where state tax adjustment affects federal tax liability

Present Law

In general, the Code requires that taxes be assessed within three years after the date a return is filed.[1345] If an assessment is not made within the required time period, the tax generally cannot be assessed or collected at any future time. The statute of limitations with respect to claims for refund generally expires three years from the time the return was filed or two years from the time the tax was paid, whichever is later.[1346]

Several important exceptions in the Code extend the statute of limitations. If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[1347] If a taxpayer has engaged in a listed transaction and has failed to include on any return or statement for any taxable year any information required under section 6011 to be included with such return or statement, the statute of limitations with respect to such transaction will not expire before the date that is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in section 6111) satisfies the list maintenance requirements (as defined in

[1345] See, section 6501(a). A return that is filed before the date on which it is due is considered to be filed on the required due date. Sec. 6501(b)(1).

[1346] Sec. 6511.

[1347] Sec. 6501(e).

section 6112) with respect to a request by the Secretary.[1348] In the case of a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[1349] The statute of limitations also may be extended by taxpayer consent.[1350]

Description of Proposal

The proposal creates an additional exception to the general three-year statute of limitations for assessment of Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations is extended to the greater of: (1) one year from the date the taxpayer first files an amended tax return with the IRS reflecting adjustments to the State or local tax return; or (2) two years from the date the IRS first receives information from the State or local revenue agency under an information sharing agreement in place between the IRS and the State or local revenue agency. The statute of limitations is extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment. The statute of limitations is not further extended if the taxpayer files additional amended returns for the same tax periods as the initial amended return or if the IRS receives additional information from the State or local revenue agency under an information sharing agreement.

The statute of limitations on claims for refund is extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the State or local examination report would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

Effective date.–The proposal is effective for returns required to be filed after December 31, 2011.

Analysis

As the Supreme Court noted, "Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values, and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensible element of fairness as well as of practical administration of an income tax policy."[1351] Based on this strong policy interest in permitting finality with respect to tax periods, the exceptions to the general rule are relatively few and the burden of proving that an exception applies rests with the government to overcome the bar on assessment. These exceptions are predicated on the theory that the statute of limitations should not run in cases of taxpayer misconduct or lack of candor or if the failure to identify an issue was

[1348] Sec. 6501(c)(10).

[1349] Sec. 6501(c).

[1350] Sec. 6501(c)(4).

[1351] *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 300 (1946).

due to factors outside the control of either the taxpayer or the government. For example, there is no statute of limitations in the case of a false or fraudulent return. In that case, the taxpayer who has filed a fraudulent return with intent to evade tax hardly is in a position to complain of the fairness of a rule that facilitates the IRS's collection of the tax due. Similarly, in cases in which a taxpayer has omitted substantial items of income, the IRS is provided with an additional three years to make an assessment.

An example of an exception based on acknowledgement that there may be circumstances under which neither the taxpayer nor the IRS has the information necessary to properly compute tax is the extension in the case of foreign tax credits. The IRS may assess a deficiency attributable to the reduction of excess foreign tax credits or disallowed foreign oil and gas taxes for a period of up to one year after the statute of limitations would generally expire for the taxable year of the excess or disallowed credits resulting in the carryback.[1352] To the extent that the proposal permits both the taxpayer and the IRS to adjust the Federal return to reflect the corrected State or local tax, it would be somewhat analogous to the treatment of foreign tax credits.

The proposal extends the statute of limitations only in cases in which adjustments to State or local taxes create an additional Federal tax liability. Proponents argue that an extension is appropriate because the IRS is often unaware of a State or local adjustment affecting Federal tax liability until the general three-year statute of limitations has expired, while the taxpayer is aware of such adjustment on a more timely basis. The limited resources available for examinations of returns necessarily results in relatively few audits; this proposal permits the IRS to leverage the information received from a State or local agency to determine whether to select the return for examination.

The factual basis of this argument assumes that the taxpayer understands the relationship between State and Federal income tax liabilities, and is simply concealing the State or local proceeding and determination from the IRS. Proponents of the proposal suggest that taxpayers manipulate the timing of the completion of State or local tax cases until after the Federal statute of limitations has expired to preclude assessment at the Federal level. Proponents also note that taxpayers who file amended returns with State agencies on which they claim refunds or reductions in tax often fail to amend the Federal return for the same period to reflect a correlative adjustment.

Opponents of the proposal may argue that such assumptions are not warranted, and to the extent such cases occur, they do not represent the full spectrum of cases in which State or local tax adjustments may occur. The mere fact of a State or local revenue agency determination is distinguishable from other situations in which the statute of limitations is extended, such as those in which a taxpayer fails to disclose information on a tax return. A State or local tax adjustment may or may not be based on information that is available from the face of the filed tax return. If the information necessary to make an adjustment is available from the face of the return (i.e., the taxpayer did not fail to disclose information), one may argue that the burden should be on the

[1352] Sec. 6501(i).

taxing agencies to share information in a manner that would allow assessments to be made in a timely manner, rather than extending the statute of limitations.

Rather than providing a general exception to the statute of limitations in the case of any State or local determination that results in an increase to Federal tax liability, the proposed extension of the limitations period could be limited in some manner. For example, the statute could provide the exception does not apply if a taxpayer can demonstrate that information adequate to identify the issue raised by the State or local authorities was disclosed on the Federal return. Alternatively, the statute could provide that the exception only applies if, in addition to the existence of a State tax adjustment, the resulting Federal adjustment would support assertion of an accuracy penalty under section 6662.

The proposal permits an extension of the statute of limitation based on notice from the State or local agency to the IRS under an information sharing agreement. Accordingly, the date on which such notice is first provided to the IRS may determine the extent to which the limitations period is extended, but is not within the taxpayer's control or knowledge. In contrast, most of the exceptions to the three-year limitations period are based on information that is clearly available to the taxpayer. If this proposal is adopted, a mechanism to provide the taxpayer with contemporaneous notice that the State has notified the IRS is needed.

Prior Action

A similar proposal was included in the President's Budget for fiscal years 2009, 2010, and 2011.

6. Improve investigative disclosure statute

Present Law

The Code defines return information very broadly, including a taxpayer's identity and "whether the taxpayer's return was, is being, or will be examined or subject to other investigation." In general, returns and return information are confidential and cannot be disclosed unless an exception to this general rule applies. One exception permits Treasury and IRS personnel to disclose return information to the extent necessary to obtain information not otherwise reasonably available in the course of an audit or investigation as prescribed by regulation.[1353] A "disclosure of return information to the extent necessary" is a facts-and-circumstances test in which the Treasury or IRS employee reasonably believes a disclosure of return information is necessary to obtain information to perform properly his or her official duties, or to accomplish properly the activities connected with carrying out those official duties. In this context, the term "necessary" does not mean essential or indispensible, but rather "appropriate and helpful in obtaining the information sought."[1354]

[1353] Sec. 6103(k)(6).

[1354] Internal Revenue Service, I.R.M. 11.3.21.2 *Investigative Disclosure* (March 28, 2008).

The Treasury regulations permit Treasury and IRS personnel to identify themselves, their organizational affiliation, and the nature of an investigation when contacting third parties in connection with a civil or criminal tax investigation:

> Internal Revenue and TIGTA employees may identify themselves, their organizational affiliation (e.g. Internal Revenue Service (IRS), Criminal Investigation (CI) or TIGTA, Office of Investigations (OI), and the nature of their investigation, when making an oral, written or electronic contact with a third party witness. Permitted disclosures include, but are not limited to, the use and presentation of any identification media (such as a Federal agency badge, credential, or business card) or the use of an information document request, summons, or correspondence on Federal agency letterhead or which bears a return address or signature block that reveals affiliation with the Federal agency.[1355]

The Treasury regulations do not specifically provide that the identity of the taxpayer under investigation may be disclosed routinely as part of the IRS employee's identification of the nature of the investigation. The IRS has been the subject of lawsuits over the disclosure of the fact that a taxpayer is under criminal investigation.[1356]

Description of Proposal

Section 6103 is amended to provide that Treasury and IRS officers and employees are not prohibited from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

Effective date.−The proposal is effective for disclosures made after the date of enactment.

Analysis

The proposal would make it unnecessary for a revenue agent to determine whether it is necessary to disclose the nature and subject of an investigation (including the identity of the person being investigated) when contacting third parties in connection with a civil or criminal tax investigation. Some argue that identifying the taxpayer and the nature of the investigation (civil or criminal) are items of tax information that every witness will want to know. On the other hand, some argue that there is a particular sensitivity to associating a taxpayer with a criminal investigation and that such disclosures should be made only if the witness is not willing to provide the information sought without such a disclosure.

Proponents of the proposal argue that eliminating the facts-and-circumstances test with respect to the disclosure of taxpayer identity would bring some certainty as to what is a permissible disclosure. Opponent of the proposal argue that the balance between a taxpayer's

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[1355] Treas. Reg. sec. 301.6103(k)(6)-1(a)(3).

[1356] For example, see *Snider v. United States*, 468 F.3d 500 (8th Cir. 2006); *Gandy v. United States*, 234 F.3d 281 (5th Cir. 2000).

reasonable expectation of privacy and effective tax administration is upset if the IRS is given blanket authority to disclose the nature and target of an investigation in all circumstances. Proponents of the proposal note, however, that the disclosure is permissive rather than mandatory and that agents may still use their discretion as to whether a disclosure is necessary.

Prior Action

The same proposal was included in the President's fiscal year 2009, 2010, and 2011 budget proposals.

7. Require electronically filed returns be printed with a 2-D bar code

Present Law

Every citizen, whether residing in or outside the United States, and every resident of the United States must file an income tax return if the individual has income that equals or exceeds the exemption amount.[1357] Treasury regulations require taxpayers to make this return using a Form 1040.[1358] Similarly, every corporation subject to Federal income tax, regardless of the amount of its gross or taxable income for the taxable year, is required to file return.[1359]

In 1998, Congress declared a policy that (1) paperless filing should be the preferred and most convenient means of filing Federal tax and information returns, (2) the IRS's goal should be to receive at least 80 percent of all returns electronically by 2007, and (3) the IRS should encourage private-sector competition to increase electronic filing.[1360] Section 6011(f), also enacted in 1998, authorizes the Treasury to advertise the benefits of electronic tax administration programs and to make payment of appropriate incentives for electronically filed returns.

Treasury is generally authorized to prescribe regulations providing standards for determining which returns must be filed on magnetic media or in other machine-readable form. However, except under certain circumstances, Treasury "may not require returns of any tax imposed by subtitle A on individuals, estates, and trusts, to be other than on paper forms supplied by the Secretary."[1361]

Description of Proposal

The proposal requires that taxpayers who prepare their returns electronically but print and file the returns on paper must print their returns with a 2-D bar code. A 2-D bar code program

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[1357] Sec. 6012(a)(1); Treas. Reg. sec. 1.6012-1(a)(1).

[1358] Treas. Reg. sec. 1.6012-1(a)(6).

[1359] Sec. 6012(a)(2).

[1360] The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, sec. 2001.

[1361] Sec. 6011(e)(1).

enables the IRS to convert paper-filed tax returns into an electronic format using scanning technology.

Effective date.−The proposal is effective for tax returns filed after December 31, 2011.

Analysis

When filing individual income tax returns, taxpayers can prepare their tax returns electronically, and can either file the returns electronically, or print and file the returns on paper with the IRS. In the latter cases, the IRS then manually transcribes the data on the paper returns into its computer databases. Forms filed on the IRS website, and then printed for filing, have 2-D bar codes in some (but not all) cases today. A 2-D bar code is a machine-readable representation of information encoded in a pattern of two dimensions. Due to the limitations under current law, a statutory change is necessary to require individuals, estates, or trusts to print their returns with a 2-D bar code.

The Treasury Inspector General for Tax Administration ("TIGTA") urges the IRS to use scanning technology to enter paper returns into its system, something that many states already do.[1362] In 2008, the IRS received 156.3 million individual tax returns, of which 66.4 million (42.5 percent) were paper-filed. Of the paper returns, 67 percent were prepared electronically but printed and mailed in on paper. The IRS employs up to 5,000 people during filing season to enter data from paper-filed tax returns into its databases.

The United States Government Accountability Office ("GAO") also urges the IRS to require that tax software vendors encode relevant information in a bar code that would be embedded on all paper returns printed from tax software and mailed.[1363] Tax returns that are prepared on a computer and filed on paper have the data captured and printed in a 2-D bar code capable of being read by either hand-held or high-speed scanners. The IRS can obtain electronic information such as a taxpayer's Social Security number and address through the scanning process. GAO argues that these scanning technologies allow the IRS to reduce processing costs associated with residual paper-filed tax returns and can further reduce the likelihood of transcription errors. As the amount of tax data available electronically is increased by using the 2-D bar code program, use of taxpayer information by the IRS is facilitated. When the IRS transcribes more or all return information and has it available electronically, the IRS may more easily identify noncompliant taxpayers, enabling it to focus its audit resources and avoid burdening many compliant taxpayers with unnecessary audits.

An argument against the proposal is that requiring 2-D bar codes imposes an additional cost on software providers that may be passed on to taxpayers.

[1362] *Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs*, TIGTA 2009-40-130 (September 10, 2009).

[1363] *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO 11-318SP (March 2011).

Prior Action

No prior action.

8. Require prisons located in the U.S. to provide information to the IRS

Present Law

Each July, the IRS requests data for incarcerated prisoners from the Federal Bureau of Prisons and State Departments of Corrections.[1364] The information is provided on a voluntary basis by the prisons and no Federal or State correctional institution is under legal obligation to provide this data. The requested prisoner data includes the name, date of birth, SSNs, and incarceration and release dates for each prisoner. The IRS requests these data be provided electronically by September 15th of the calendar year. However, because prisons are not legally obligated to provide data to the IRS, those that do provide data do not necessarily provide the information that the IRS requested timely or in the IRS' preferred format, reducing the IRS' ability to make use of the data. Once received from the various facilities, the IRS consolidates the data into one comprehensive prisoner file. The IRS then uses the prisoner file to prevent the issuance of fraudulent refunds to prisoners.

Currently the IRS does not have processes in place to cross reference tax returns with prison inmates list to effectively prevent fraudulent refund claims.

Description of Proposal

The proposal requires all prisons located in the United States to provide to the IRS by December 1 of each year a list of names and validated Social Security Numbers ("SSN") of all inmates serving sentences of one year or more.

Effective date.−The proposal is effective upon enactment.

Analysis

Refund fraud committed by prisoners is increasing at a significant rate. The IRS identifies that the number of fraudulent prisoner tax returns has more than doubled from 18,103 tax returns in tax year 2004 to 44,944 in tax year 2009. Fraudulent refund claims have risen from $68.1 million to $295.1 million during the same period. Ten States represent approximately 74 percent of all prisoner tax fraud − Florida, Georgia, California, Tennessee, Arizona, South Carolina, Illinois, Texas, Ohio, and Indiana.

In December 2010, the Treasury Inspector General for Tax Administration ("TIGTA") performed a review of the process the Criminal Division of the IRS used to compile the 2009 prisoner data file and found that the prisoner data file lacked managerial oversight to ensure the

[1364] *Significant Problems Still Exist with Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud,* TIGTA Reference Number 2011-40-009 (December 29, 2010).

accuracy and reliability of the file.[1365] The review identified that approximately 12 percent (360,540 records) of almost three million records in the 2009 prisoner file were either missing information and/or had inaccurate information. For example, records with missing or inaccurate SSNs, questionable dates of birth, and questionable release dates were identified. In addition, TIGTA identified that processes were not established to evaluate the completeness of information included in the 2009 prisoner file. As a result, the IRS was unable to identify whether prisoner data were received from all facilities and whether to take actions to reach out to non-reporting facilities.

Another way to ensure that the IRS has accurate prisoner data and prevent fraudulent refund claims from occurring is for the IRS to obtain prisoner information from the Social Security Administration ("SSA"). Over the past several years, the SSA has established data match agreements with prisons that house 99 percent of the inmate population. Under these agreements, the SSA can request prisoners' information, including names, Social Security account numbers, dates of birth, and confinement commencement dates from State and local correctional institutions by making incentive payments of $400 if the institution furnishes the information within 30 days after the date of confinement, and $200 if the report comes in more than 30 days but less than 90 days after confinement.[1366] Recipients are ineligible for benefits in any given month if throughout that month they are in prison.[1367] In fiscal year 2011, SSA has paid $16.8 million in incentive payments and has also increased the frequency in which it matches recipient SSNs against tax records and other data essential to identify any unreported interest, income, dividends, and pension income individuals may be receiving.[1368] These matching efforts have resulted in thousands of additional overpayment detections over the last few years.

Prior Action

No prior action.

9. Allow the IRS to absorb credit and debit card processing fees for certain tax payments

Present Law

Section 6311(a) authorizes the IRS to receive payment of taxes by any commercially acceptable means.[1369] The legislative history underlying this provision explains that commercially acceptable means includes "electronic funds transfers, including those arising from

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[1365] *Ibid.*, p. 10.

[1366] Social Security Act sec. 202(x)(3)(B),

[1367] Social Security Act sec. 1611(e)(1)(l).

[1368] *Progress Made in Detecting and Recovering Overpayments, but Management Attention Should Continue*, GAO-02-849 (September 2002).

[1369] The Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

credit cards, debit cards, and charge cards.[1370] The Treasury regulations also add payments by credit cards and debit cards to the acceptable methods of payment under section 6311.[1371] However, the IRS is prohibited from paying a fee or providing any other consideration to credit card companies for processing these transactions.[1372] Instead, the IRS has agreements with designated third-party entities to process payments for individuals or businesses that choose to use a credit or debit card to make a tax payment. These private entities charge taxpayers a convenience fee of approximately 2.49 percent to cover the credit card processing fee. Taxpayers who itemize may deduct this fee as a miscellaneous itemized deduction, subject to the two-percent limit.

Description of Proposal

The proposal amends section 6311(d) to allow the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for certain tax payments, without charging a separate processing fee to the taxpayer.

Effective date.–The proposal is effective for payments made after the date of enactment.

Analysis

This proposal may make it more cost effective for taxpayers to pay their tax debt because the IRS will now absorb the processing fee charged by the credit card company. In addition, the proposal may allow the IRS to more efficiently allocate its resources available for collection, depending on how the proposal is implemented. If broadly implemented, the IRS may realize benefits similar to those realized by any business that accepts payment by credit card: a guarantee that the funds will be paid over; reduction in the costs of handling paper checks; elimination of need to pursue collection for checks drawn on accounts with insufficient funds. The benefits available to retailers would not be fully realized, however, because unlike a retailer or other vendor, the IRS cannot offer better paying customers a discount nor can it recoup the processing fee by passing it along in the form of a price increase.

It is not clear, however, that the Administration intends a broad use of this authority. The proposal is couched in terms of "certain tax payments" which suggests that the intent is to limit this benefit. According to IRS statistics, approximately seventy-five percent of taxpayers that pay their income taxes by credit card are delinquent.[1373] If the intent is to limit the proposal to a subset of delinquent taxpayer accounts, such as those with which the IRS is negotiating an offer

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[1370] H. Conf. Rep. No. 105-220, p. 652 (1997).

[1371] Treas. Reg. sec. 301.6311-2.

[1372] Sec. 6311(d)(2).

[1373] Offices of Statistics of Income, IRS Office of Research — Forecasting and Data Analysis, *Calendar Year Projections of Credit Cards and Electronic Funds Withdrawal Transaction Volumes by Form Type and Filing Media*, July 2010.

in compromise,[1374] or those taxpayers who have been contacted by collection officers and are able to make a payment only by credit card, the proposal could result in increased collections. By absorbing the processing fee and making it more affordable for the delinquent to pay their taxes when first contacted by IRS personnel, the IRS could decrease its overall costs of collection efforts attributable to those delinquent accounts.

At the same time, however, this proposal may be disadvantageous to taxpayers for several reasons. As stated above, a large proportion of the persons who pay taxes by credit cards are delinquent. A taxpayer who uses a credit card to pay taxes is incurring additional consumer debt, possibly for a long period of time, and must pay the accompanying interest payments at a high rate. If the same taxpayer had instead agreed to an extension of the deadline for collection or entered into a long-term installment agreement with the IRS, the taxpayer would pay interest payments at a lower rate. In addition, credit card issuers may view taxpayers who use their cards to pay taxes as higher risk clients, and as a result, alter terms of the credit card agreement, raise the interest rate, lower the credit limit, or even cancel the credit card. Moreover, taxpayers taking advantage of this proposal would have to be mindful that certain bankruptcy proceedings (such as those under Chapter 7) will not discharge credit card debt incurred from taxes such that the credit card lender could continue to pursue normal collection after one's bankruptcy proceeding is over, without much warning.

Prior Action

No prior action.

[1374] An offer in compromise is an agreement that settles the taxpayer's tax liabilities for less than the full amount owed.

D. Expand Penalties

1. Impose a penalty on failure to comply with requirements for electronic filing of returns

Present Law

The Code authorizes the IRS to issue regulations specifying which returns must be filed electronically.[1375] There are several limitations on this authority. First, it can only apply to persons required to file at least 250 returns during the year.[1376] Second, the IRS is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper.

If a corporation fails to file electronically a corporate income tax return when required, the corporation is deemed to have failed to file a return.[1377] The addition to tax for failure to file a return is five percent of the amount of tax required to be shown on the return for the first month in which the failure occurs and an additional five percent for each additional month (or fraction thereof) up to 25 percent.[1378]

For failure to file a tax-exempt organization return, the addition to tax is $20 a day for each day the failure continues. The maximum amount per return is the lesser of $10,000 or five percent of the organization's gross receipts for the year. Organizations with annual gross receipts exceeding $1 million, however, are subject to an addition to tax of $100 per day, with a maximum of $50,000.

The Code specifically authorizes the Secretary to offer incentives to encourage electronic filing.

Description of Proposal

The proposal establishes an assessable penalty in the amount of $25,000 for a corporation or $5,000 for a tax-exempt organization for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. For failure to file in any format, the existing penalty remains in effect, and the proposed penalty does not apply.

Effective date.–The proposal is effective for returns required to be electronically filed after December 31, 2011.

[1375] Sec. 6011(e). For returns filed after December 31, 2010, individual income tax returns are required to be filed electronically if the return is filed by a tax return preparer that files more than ten individual tax returns during the year. Sec. 6011(e)(3).

[1376] Partnerships with more than 100 partners are required to file electronically. Sec. 6011(e)(2).

[1377] Treas. Reg. sec. 301.6011-5(c).

[1378] Sec. 6651(a).

Analysis

Proponents of the penalty may argue that a penalty is justified because a threat of a penalty encourages compliance with electronic filing requirements, which in turn promote efficiency and provide cost savings for the IRS. Electronic filing increases efficiency because the IRS is better able to make use of its computer infrastructure to target returns with audit potential. This focus, in turn, allows the IRS to utilize its resources in areas in which such efforts would be most fruitful. In support, proponents point to the Government Accountability Office ("GAO") study which reported that electronic filing has enabled the IRS to close two paper processing centers and save 1,600 staff years.[1379] Along similar lines, the Treasury Inspector General for Tax Administration also has noted significant cost savings, reporting that a paper return is over nine times more costly to process than a return submitted electronically and has a far greater error rate.[1380]

Advocates for a penalty specific to e-filing failures also argue that the existing failure to file penalty is inadequate to promote e-filing because it is linked to the existence of an underpayment of tax. Thus, a corporation entitled to a refund or credit may not incur a penalty despite the significant increase in costs incurred in processing the paper returns.

Others argue that, despite the foregoing facts about increased efficiencies, a $25,000 penalty is likely to be disproportionate to any costs or efficiency loss incurred by the IRS. Opponents note that the IRS already has the ability to penalize noncompliance with mandatory e-filing regulations. Under the Treasury regulations, failure to file electronically when required to do so can be treated as a failure to file a return, thus triggering the existing penalty for failing to file, rendering a new monetary penalty unnecessary. In addition, because the e-filing regulations provide that a paper return is not considered to have been filed, the specter of elections being disregarded if submitted on paper operates as a disincentive to ignore the e-file mandate.

Some may argue that the IRS should use incentives, as authorized by the Code, rather than penalties to encourage electronic filing. Proponents of the proposal counter that it is not appropriate for the IRS to offer incentives for what taxpayers are obligated to do, and the authority to offer incentives should be reserved to encourage electronic filing by those not yet required to do so. They further argue that, in the absence of hardship, the burden on a taxpayer to file electronically is minimal and yields significant tax administration benefits for the IRS.

[1379] U.S. Government Accountability Office, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, GAO-07-27, November 2006, p.3.

[1380] It costs the IRS only $0.35 to process an e-filed return, versus $2.87 for a paper filed return, according to a study. Higher rates of processing errors on paper returns are attributed to the need to input information into IRS computers. Treasury Inspector General for Tax Administration, *Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs,* TIGTA 2009-40-130, September 10, 2009.

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009, 2010 and 2011 budget proposals.

2. Increase penalty imposed on paid preparers who fail to comply with Earned Income Tax Credit ("EITC") due diligence requirements

Present Law

Certain low- and moderate-income workers are eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EITC 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 EITC generally equals a specified percentage of earned income[1381] 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 adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC 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.

The Taxpayer Relief Act of 1997[1382] added section 6695(g), which requires tax return preparers to meet the EITC due diligence requirements as set forth in regulations prescribed by the Secretary of the Treasury and imposes a $100 penalty for each failure to comply. Treasury regulations establish four due diligence rules[1383] related to completion of an eligibility checklist, computation of the credit, knowledge, and record retention. First, the tax preparer must complete either Form 8867 or its equivalent, and complete an eligibility checklist based on information provided by the taxpayer for the tax preparer. Second, the preparer must keep the EITC worksheet or equivalent that demonstrates how the EITC was computed. Third, the preparer must not know or have reason to know that any information used in determining the taxpayer's eligibility for, or the amount of, the EITC is incorrect, incomplete or inconsistent. In satisfying this knowledge requirement, the taxpayer must also (1) not ignore the implications of information furnished or known, (2) make reasonable inquiries if a reasonable and well-informed tax return preparer, knowledgeable in the law, would conclude the information furnished appears to be incorrect, inconsistent or incomplete, and (3) document in his/her records any additional inquiries and responses made. Lastly, the diligence requirements relating to record retention require that the preparer retain the Form 8867 (or its equivalent) and the EITC worksheet,

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[1381] Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

[1382] Pub. L. No. 105-34.

[1383] Treas. Reg. sec. 1.9952-2.

maintain a record of how and when the information used to complete these forms was obtained, verify the identity of the person furnishing the information, and retain the records for three years after the June 30th following the date the return or claim was presented for signature.

Description of Proposal

The proposal increases the penalty amount from $100 to $500 for each failure to comply with the due diligence requirements.

Effective date.−The proposal is effective for returns required to be filed after December 31, 2011.

Analysis

The Internal Revenue Service ("IRS") estimates that between $11 billion and almost $14 billion in erroneous EITC clams are paid annually.[1384] Approximately 60 percent of errors fall into three key categories: (1) claiming a child who does not meet the age, relationship or residency requirement; (2) filing as single or head of household when legally married; and (3) over- or under-reporting income or business expenses to maximize the credit.[1385] Because two-thirds of all EITC claims are prepared by paid tax return preparers, proponents argue that the increase in penalty amount would provide an incentive for tax return preparers to comply with the due diligence requirements and thus reduce the likelihood of taxpayer error and fraud.

The IRS also recognizes the role tax return preparers play in ensuring compliance with EITC requirements. In January 2010, the IRS announced plans to strengthen its regulations of tax return preparers. Currently, the level of oversight the IRS provides for each tax return preparer depends on whether the preparer holds a professional license, is enrolled to practice before the IRS, and chooses to electronically file (e-file).[1386]

Prior Action

No prior action.

[1384] IRS EITC Fact Sheet. Data for TY 2008 through June 30, 2009. Available at: http://www.eitc.irs.gov/rptoolkit/compliance.

[1385] *Ibid.*

[1386] http://www.eitc.irs.gov/rptoolkit/faqs/fraud.

E. Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms

1. Make permanent the portability of unused exemption between spouses

Present Law

Under present law, a unified credit is available with respect to taxable transfers by gift and at death.[1387] The unified credit offsets tax computed at the lowest estate and gift tax rates. Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("the 2010 Act"),[1388] the unified credit effectively exempts $5 million from estate or gift tax for decedents dying and gifts made in 2011. This $5 million exemption amount is indexed for inflation for decedents dying and gifts made in 2012. The estate and gift tax provisions of the 2010 Act expire at the end of 2012, and the law that would have been in effect if the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") had not been enacted again will apply. Therefore, for decedents dying and gifts made after December 31, 2012, the unified credit effectively exempts $1 million in taxable transfers from estate or gift tax.

Under a temporary provision enacted as part of the 2010 Act,[1389] any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.[1390]

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last such deceased spouse.[1391] A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own $5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. The

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[1387] Sec. 2010.

[1388] See Pub. L. No. 111-312 (December 17, 2010).

[1389] See sec. 303 of Pub. L. No. 111-312 (December 17, 2010).

[1390] The provision does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

[1391] The last deceased spouse limitation applies whether or not the last deceased spouse has any unused exclusion or the last deceased spouse's estate makes a timely election.

Secretary of the Treasury shall prescribe regulations as may be appropriate and necessary to carry out the rules described in this paragraph.

Example 1.−Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2.−Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3.−Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount,[1392] which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the temporary provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

The temporary rules providing for the portability of unused exemption between spouses do not apply to estates of decedents dying or gifts made after December 31, 2012.

[1392] The 2010 Act added new section 2010(c)(4), which generally defines "deceased spousal unused exclusion amount" of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the temporary provision.

Description of Proposal

The proposal makes permanent the temporary 2010 Act provisions that provide for portability of unused exemption between spouses.

Effective date.−The proposal is effective for estates of decedents dying or gifts made after December 31, 2012.

Analysis

Simplification of wealth transfer tax planning

Proponents of portability between spouses of unused exemption generally argue that it eliminates the need for inefficient and costly tax planning and results in similarly situated taxpayers being treated equally.[1393]

Assume, for example, that Husband and Wife each have $5 million in assets titled in their separate names and that neither has engaged in estate planning to preserve their exemptions. Husband and Wife both die in 2011 (when the effective exemption amount is $5 million), and each bequeaths $5 million to Son. Husband and Wife collectively have used $10 million in exemption, successfully maximizing use of their available exemptions. Now assume that Husband dies in early 2011 and bequeaths his $5 million estate to Wife. No estate tax is due on the transfer, because the transfer qualifies for the 100-percent marital deduction. Wife, who now owns $10 million in assets, dies in late 2011 and bequeaths her entire estate to Son. In the absence of the 2010 Act provision that provides for portability of unused exemption between spouses, Wife would have available only her own $5 million exemption to offset the transfer to Son; the additional $5 million transferred to Son would be subject to estate tax, and Husband's estate tax exemption would not have been used. Under the temporary 2010 Act provision, however, Wife is permitted to use both her own $5 million exemption and Husband's $5 million exemption to shield the $10 million bequest to Son from estate tax (provided Husband's personal representative made a timely election on Husband's estate tax return). This automatic portability of unused exemption between spouses is not available for decedents dying after December 31, 2012.

To maximize the use of a couple's estate tax exemption amounts in the absence of exemption portability, couples frequently employ a tax planning strategy under which assets of the first spouse to die pass into a "credit shelter trust" at the time of that spouse's death. The trust is designed to benefit the surviving spouse during his or her lifetime while using the exemption of the first spouse to die to shield trust assets that ultimately will pass to another beneficiary (such as Son in the above example) from estate tax. To take advantage of this strategy, couples generally must hire a lawyer to draft the trust documents and also must ensure

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[1393] See, e.g., American Institute of Certified Public Accountants, Tax Simplification Recommendations (April 30, 1997), reproduced in 97 *Tax Notes International,* p. 95-21 (May 16, 1997); American Bar Association Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes (2004) (hereafter, "ABA Task Force Report"), pp. 99-101.

that each spouse has sufficient assets titled in his or her separate name to fund a credit shelter trust up to the full amount of his or her exemption amount. Couples who do not have such trusts in place at the death of the first spouse to die may not be able to take full advantage of both spouses' exemption amounts. Even where couples do have such trusts in place, if the first spouse to die does not have sufficient assets titled in his or her own name at the time of death to fund the trust up to the amount of the then-applicable exemption amount, a portion of such spouse's exemption amount may be lost.

For these reasons, the American Bar Association Task Force on Wealth Transfer Taxes (the "ABA Task Force") has argued that "the law rewards both sophisticated planning and constant reallocation of wealth, but does not offer the same benefits to couples who do not engage in sophisticated planning or whose assets do not lend themselves to appropriate allocation, such as property held in a qualified retirement plan."[1394] Therefore, allowing for portability between spouses of unused exemption arguably would contribute to simplicity and facilitate compliance with the law, because it largely would eliminate the need for couples to employ the credit shelter trust strategy or to monitor and adjust the titling of assets.

Although proponents of portability generally assert that portability simply allows spouses to achieve the results that otherwise would have been achieved through costly tax planning and re-titling of assets, a portability provision (depending on how it is drafted) may allow couples to achieve better results than they could have achieved through the best estate planning. Assume, for example, that Wife dies when Husband's and Wife's collective assets were $4 million. The most exemption that Wife's estate could have used is $4 million (which could, for example, be achieved by titling all of the couple's assets in Wife's name). Husband dies a decade later with $10 million in assets, $5 million of which would be exempt under his own $5 million exemption. Combined, the maximum amount of exemption Wife and Husband could have used without portability would have been $9 million. With portability, it may be possible for Husband and Wife to use a combined amount of $10 million (assuming that Wife used none of her $5 million exemption because she had made no taxable gifts and either had no taxable estate at death or bequeathed all assets to Husband). If this situation were viewed as problematic, it could be addressed through a rule that would limit the amount of exemption that could be passed to a surviving spouse to the lesser of (1) the combined value of the spouses' assets as of the death of the first spouse to die or (2) the unused exemption amount of the first spouse to die. However, such a rule would add complexity and raise administrability concerns, as one would need to value the assets of both the decedent and the surviving spouse as of the death of the first spouse to die.

Administrability issues

Portability of unused exemption raises a number of other administrability issues. For example, to determine the amount of additional exemption available to a surviving spouse, one must know the amount of unused exemption remaining at the death of the first spouse to die. Under the temporary 2010 Act provision, for example, unused exemption may be made available

[1394] ABA Task Force Report, pp. 99-100.

to a surviving spouse regardless of the value of assets owned at the time of the first spouse's death, e.g., even where the first spouse to die otherwise would not have been required to file an estate tax return because the estate assets were below filing thresholds. If no return were filed, it would be virtually impossible at the death of the surviving spouse to determine the amount of unused exemption that remained at the death of the first spouse to die, which may have occurred years or even decades earlier.[1395] These problems could be mitigated by requiring (as in the temporary provision) that, in order to preserve unused exemption for a surviving spouse, the estate of the first spouse to die file a return computing the amount of unused exemption. However, such a return requirement likely would result in the filing of numerous returns solely to preserve exemption for a surviving spouse, potentially burdening the IRS. In many cases, the filings will prove to have been unnecessary, as the surviving spouse ultimately will have no need for additional exemption to offset transfers. Nevertheless, estates are likely to file prophylactic returns to preserve unused exemption, because of the possibility (however remote) that a surviving spouse may accumulate significant additional wealth by the time of his or her subsequent death.

Furthermore, even if a return is filed to preserve unused exemption, the IRS likely will have little incentive to examine the return at the death of the first spouse to die. The IRS has limited resources, and examination of a return filed solely to preserve unused exemption generally would not lead to additional tax due from the estate of the first spouse to die. In addition, by the time the surviving spouse dies, the statute of limitations with respect to the estate of the first spouse may have expired. The temporary provision attempts to address this issue by providing that, notwithstanding any statute of limitations that may apply with respect to the estate of the first spouse to die, the IRS may examine the return of the deceased spouse for purposes of determining the amount of unused exemption available for the surviving spouse (though not for purposes of adjusting the liability of the estate of the first spouse to die). Even so, it could be difficult for the IRS to adjust the claimed amount of unused exemption. Particularly in situations in which the spouses die many years apart, there may not be contemporaneous records to support the claimed unused exemption amount.[1396]

Multiple marriage situations

Portability of unused exemption presents additional policy and complexity issues in multiple marriage situations. Assume, for example, the estate tax effective exemption amount is $5 million. If a surviving spouse is predeceased by more than one spouse, should that surviving

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[1395] A similar issue may arise if, after many years, the surviving spouse instead makes taxable gifts using ported exemption.

[1396] Designing a portability regime in which the estate and gift taxes are not reunified (i.e., if the gift tax exemption and rates are different from the estate tax exemption and rates) would raise additional policy issues. For example, assume the estate tax exemption is $5 million and the gift tax exemption is $1 million. Husband dies with no taxable estate, but he used $500,000 of exemption on lifetime taxable gifts, such that he passes a total of $4.5 million unused exemption to Wife. Should Wife be permitted to use only $500,000 of this amount to offset lifetime taxable gifts (the amount of Husband's unused gift tax exemption), with the remainder available for use only at Wife's death? Should such a regime include a gift tax cap and a separate cumulative cap on the amount of exemption a person can receive from predeceased spouses?

spouse be allowed to use the full amount of unused exemption of all predeceased spouses (e.g., should the surviving spouse have available (in addition to his own $5 million exemption) as much as $5 million from each of two predeceased spouses, for a total of $15 million)? The temporary provision attempts to address this question in two ways. First, the provision caps the cumulative amount of additional ported exemption from predeceased spouses from which a surviving spouse may benefit at the basic exemption amount then in effect ($5 million in this example). Second, the provision permits a surviving spouse to benefit only from the unused exemption of such surviving spouse's most recently deceased spouse.

To highlight another issue, assume that the estate tax exemption amount is $5 million and that Husband 1 dies with no taxable estate and having made no taxable gifts, such that his entire $5 million exemption is available for Wife, in addition to her own exemption. Therefore, Wife has $10 million for her use for purposes of making lifetime gifts or bequests. Further assume that Wife remarries and predeceases Husband 2. From a policy perspective, one may question whether the amount of unused exemption passed from Husband 1 to Wife should be available to Husband 2 following Wife's death. As noted above, the temporary present-law provision caps the amount of exemption a surviving spouse may receive from all predeceased spouses at the basic exemption amount then in effect (e.g., $5 million in 2011), such that in this situation, Husband 2 could benefit from only $5 million of Wife's $10 million unused exemption. But the temporary provision does not differentiate between a decedent's own exemption and ported exemption for this purpose. So, for example, if Wife had made taxable gifts prior to Husband 1's death and had only $2 million of her own exemption remaining, and subsequently received $5 million of unused exemption from Husband 1 (for a total of $7 million), she could still pass $5 million of unused exemption to Husband 2 at her death, even though a portion of this amount originally had been the exemption of Husband 1. The Congress could craft a rule to address this issue, but such a rule would raise additional administrability issues. Such a rule, for example, would make relevant at the death of Husband 2 the amount of unused exemption passed from Husband 1 to Wife at Husband 1's death. As an alternative, one simply could provide that unused exemption received from Husband 1 expires if Wife remarries.

Prior Action

A temporary provision that generally provides for portability of unused exemption between spouses through December 31, 2012, was enacted as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.[1397]

2. Require consistency in value for transfer and income tax purposes

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. 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

[1397] See sec. 303 of Pub. L. No. 111-312 (December 17, 2010).

alternate valuation date, if elected by the executor.[1398] 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.[1399] 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.[1400] 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 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.[1401]

For property acquired by gift, the basis of the property in the hands of the donee generally is the same as it was in the hands of the donor. However, for the purpose of determining loss on subsequent sale, the basis of property in the hands of the donee is the lesser of the donor's basis or the fair market value of the property at the time of the gift.[1402]

Description of Proposal

The proposal requires that the basis of property under section 1014 of an asset acquired from a decedent generally must equal the value of that property for estate tax purposes. The basis of property received by lifetime gift generally must equal the donor's basis determined under section 1015. The basis of property acquired from a decedent to whose estate section 1022 is applicable is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death.[1403] Under the proposal, the basis in the hands of the recipient can be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments).

[1398] If a timely election is made, the basis of property acquired from a decedent who died during 2010 is determined under section 1022 of the Code. Under section 1022, a taxpayer's basis generally is the lesser of the decedent's adjusted basis and the fair market value of the property on the date of the decedent's death. Section 1022 also provides that an executor may increase the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to special rules and exceptions.

[1399] Treas. Reg. sec. 1.1014-3(a).

[1400] See Rev. Rul. 54-97, 1954-1 C.B. 113.

[1401] See TAM 199933001 (January 7, 1999).

[1402] Sec. 1015(a).

[1403] As discussed above, section 1022 permits certain increases in the adjusted basis of property acquired from a decedent whose estate elects application of section 1022. Although the proposal states only that an heir's basis under section 1022 would be limited to the lesser of the decedent's adjusted basis or the fair market value of the property, the Joint Committee staff assumes for purposes of this analysis that the proposal's reference to "adjusted basis" would include the basis increases permitted under sections 1022(b) and (c).

In addition to requiring consistency in values for transfer and income tax purposes, the proposal imposes a reporting requirement. The executor of a decedent's estate and the donor of a lifetime gift are required to report to both the recipient and the IRS the information necessary to determine the recipient's basis under the proposal.

The proposal provides for regulatory authority necessary to implement and administer the requirements of the proposal, including establishing rules for: (1) situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503 (e.g., pursuant to the gift tax annual exclusion); (2) situations in which the surviving joint tenant or other recipient may have better information than the executor; and (3) the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

Effective date.−The proposal is effective on the date of enactment.

Analysis

Providing an heir with fair market value information gives the heir records to improve reporting of income upon future realization of gain. Providing the IRS with the same information would better enable the IRS to challenge attempts to underreport gain upon a subsequent realization of that gain.

Under present law, generally the incentive exists for an executor of an estate or a donor of a lifetime gift to offer low estimates of the value of assets for estate or gift tax purposes in order to minimize the amount of transfer tax. For the purpose of determining gain or loss on an inherited asset or on an asset received by gift, however, generally the recipient would prefer a higher basis.[1404] The government is potentially whipsawed by inconsistent valuations. For example, the IRS has ruled that while value as appraised for estate tax purposes provides a presumptive value for the basis of inherited property in the hands of a beneficiary, such estate tax valuation generally is not conclusive.[1405] In a case discussed in a technical advice memorandum,[1406] at the time of the decedent's death the taxpayer owned stock in two closely held corporations. On audit, the IRS proposed a higher value for the stock than the value the executor provided on the estate tax return. The estate subsequently argued for a lower valuation, and the IRS agreed to an amount in between the two parties' initial valuations. Following a redemption of the inherited stock from the beneficiary, the beneficiary (in an amended return for the taxable year of redemption) claimed a basis in the stock that was higher than both the original estate tax return value and the agreed upon value.

[1404] This preference is especially clear in the case of a spouse of the decedent. That spouse will not, for example, bear the burden of an estate tax on his or her bequest. Other beneficiaries generally will bear the burden of the estate tax and therefore may have competing preferences.

[1405] In Rev. Rul. 54-97, 1954-1 C.B. 113, the IRS concluded, "Except where the taxpayer is estopped by his previous actions or statements, such value [the value of the property as determined for estate tax purposes] is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence."

[1406] TAM 199933001 (January 7, 1999).

Underlying the rebuttable presumption rule set forth in the technical advice memorandum is the theory that a taxpayer should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination or benefit from it. This theory represents an application of an estoppel principle that is used outside the context of the estate tax. Where, however, a taxpayer succeeds in presenting clear and convincing evidence of a higher basis than the value used for estate tax purposes, this principle conflicts with one rationale for the section 1014 basis step-up rule, which applies for purposes of determining the basis in assets acquired from a decedent who died before 2010 or who dies after 2010. Some analysts argue that the step-up of an asset's basis at death is an appropriate adjustment to prevent property transferred at death from being subject to both Federal income tax and estate tax. If the basis in the hands of the heir exceeds the value used for estate tax purposes, an exemption from income tax in excess of the appreciation in the decedent's hands has been created. By helping to ensure consistency in value for estate and income tax purposes, the proposal at least mitigates the whipsawing of the government that may occur under present law.

In general, in the computation of capital gain or loss, establishing basis in property is a problem for taxpayers and the IRS, because the basis in the property becomes important for determining tax liability only when the asset is sold, often many years after the asset is acquired. Taxpayers may lose records in the interim. The difficulty would be particularly acute where the taxpayer did not purchase the asset in question and consequently would have no records (e.g., receipts or other purchase documentation) to begin with. Thus, another rationale for the basis step-up rule of present law section 1014 is to provide administrative simplicity for the heir and the IRS because the heir's fair market value basis will potentially already have been determined for estate tax purposes. The proposal achieves this administrative goal by having basis reported at the time an asset is bequeathed, thereby establishing a record comparable to purchase documentation. Present law arguably fails to achieve this objective, both because the executor is not required to report the estate tax value to the heir, and because the heir is not required in all cases to use such value in determining basis.

Under the proposal there would be instances in which the value of an asset reported by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is artificially low, and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir's basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation, and an heir may sell an asset before the determination of value for estate tax purposes. Nevertheless, supplemental reporting requirements would be imposed for post-filing adjustment of the fair market value as determined for Federal estate or gift tax purpose.

Under the proposal, the basis in the hands of the recipient can be no *greater than* the value of that property as determined for estate or gift tax purposes. Where a recipient of a gift or bequest believes the transferor overstated the value of transferred property for transfer tax purposes, it is the understanding of the Joint Committee staff that the proposal would permit the recipient to claim a basis *lower than* the value claimed for transfer tax purposes. This rule likely

is designed to protect recipients of gifts and bequests from accuracy-related penalties under section 6662 on a subsequent disposition of property in situations in which the transferor overstated the value of such property for transfer tax purposes.

Prior Action

Similar proposals were included in the President's fiscal year 2000, 2001, 2010, and 2011 budget proposals.

3. Modify rules on transfer tax valuation discounts

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.[1407] The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[1408]

If actual sales prices and bona fide bid and ask prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook in the nation and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.[1409]

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of stock held by a 50-percent shareholder might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts used under present law are discussed below.[1410] In many cases courts apply more than one discount. The

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[1407] Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternate valuation date if the executor so elects) in the case of the estate tax.

[1408] Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

[1409] Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237.

[1410] Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key

theories of some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely-held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.[1411] Minority discounts arise from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.[1412]

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests often are less attractive to investors and have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,[1413] but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for

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man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities)* discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

[1411] See Rev. Rul. 93-12, 1993-2 C.B. 202; *Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner,* 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner,* 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

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

[1412] See David T. Lewis and Andrea Chomakos, The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities (ABA Publishing 2004), p. 11.

[1413] E.g., *Central Trust Co. v. United States*, 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner*, T.C. Memo 1989-466.

which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.[1414] Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases. However, the discount has been applied to a 100-percent ownership interest in a closely-held corporation.[1415] Marketability discounts often result in reductions in the value of transferred property of 20 to 30 percent[1416] in addition to any applicable minority discount.[1417] Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts created through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (e.g., a gift of an undivided fractional interest in real estate).[1418] Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.[1419]

[1414] Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

[1415] See, e.g., *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. ("Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.").

[1416] There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, i.e., converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

[1417] The Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

[1418] Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, para. 135.3.4 (2d ed. 1993). Courts, however, often apply a minority discount instead. See, e.g., *LeFrak v. Commissioner*, T.C. Memo 1993-526.

[1419] See, e.g., *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts can be as high as 50 percent and may overlap with the marketability discount.[1420]

Special rules regarding restrictions on liquidation (section 2704(b))

Restrictions on the liquidation of an entity (or of an interest in an entity) sometimes serve as the basis for a marketability discount. Where the entity is family-controlled, however, some believe that such restrictions are included in governing documents principally to achieve a reduction in value for transfer tax purposes, but that the claimed reduction in value does not reflect the true economic value of a transferred interest in the hands of the transferee.[1421]

To address this concern, section 2704(b) provides that certain "applicable restrictions" are disregarded in determining the value of a transferred interest if the transfer is of an interest in a corporation or partnership to or for the benefit of a member of the transferor's family,[1422] and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity.[1423] An applicable restriction is a restriction that effectively limits the ability of the entity to liquidate, where (1) the restriction lapses, in whole or in part, after the transfer, or (2) the transferor or any member of the transferor's family, either alone or together, has the right after the transfer to remove, in whole or in part, the restriction.[1424] An applicable restriction does not include commercially reasonable restrictions that arise as part of certain third-party financing arrangements, or any restriction imposed, or required to be imposed, by any Federal or State law.[1425] Section 2704(b) grants the Secretary broad regulatory authority to disregard any other restriction that reduces the transfer tax value of an interest but does not reduce the value of such interest to the transferee.[1426]

Since the enactment of section 2704(b), new State statutes providing for more restrictive liquidation rights, as well as regulatory and judicial interpretations of section 2704(b), arguably

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[1420] For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

[1421] See H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1028, 1137-1138 (1990).

[1422] For purposes of section 2704, a family member includes, with respect to an individual: (1) a spouse; (2) ancestors and lineal descendants; (3) brothers and sisters; and (4) spouses of an individual described in (2) or (3). Sec. 2704(c)(2).

[1423] Sec. 2704(b)(1).

[1424] Sec. 2704(b)(2).

[1425] Sec. 2704(b)(3).

[1426] Sec. 2704(b)(4).

have limited the provision's effectiveness in curbing inappropriate marketability discounts. In its opinion in *Kerr v. Commissioner*,[1427] for example, the Tax Court asserted that current Treasury regulations expand the Code-based exception that excludes from the definition of "applicable restriction" certain State or Federal law liquidation restrictions. Indeed, instead of limiting the exception to restrictions *imposed or required to be imposed* by law (as under the language of section 2704(b)(3)(B)), the regulations provide that "[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) *that is more restrictive than* the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."[1428] The IRS generally has been unsuccessful in arguing for a more limited interpretation of this exception in court cases in which the breadth of the exception is at issue.[1429]

Description of Proposal

The proposal modifies section 2704(b) to create a category of "disregarded restrictions" that would be ignored when valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. The proposal provides that the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations.

The proposal provides that disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest in the family-controlled entity that are more restrictive than a standard to be specified in regulations. A disregarded restriction also would include a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. In determining whether a restriction may be removed by one or more members of the family after a transfer, certain interests held by charities or others who are not family members would be deemed to be held by the family. Such interests are to be identified in regulations.

Under the proposal, regulatory authority is granted, including the ability to create safe harbors under which the governing documents of a family-controlled entity could be drafted so as to avoid the application of section 2704 if certain standards are met. The proposal includes conforming changes relating to the interaction of the proposal with the transfer tax marital and charitable deductions.

Effective date.−The proposal is effective for transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

[1427] 113 T.C. 449, 472 (1999), aff'd 202 F.3d 490 (5th Cir. 2002).

[1428] Treas. Reg. sec. 25.2704-2(b) (emphasis added).

[1429] See, e.g., *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff'd 202 F.3d 490 (5th Cir. 2002); *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001).

Analysis

Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax purposes do not accurately reflect economic value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.[1430]

The proposal seeks to curb the use of family limited partnerships ("FLPs") and LLCs to create valuation discounts, specifically marketability (*i.e.*, liquidity) discounts. The proposal would achieve this goal through a more robust version of section 2704(b), under which taxpayers would be subject to greater limits on marketability discounts arising from liquidation restrictions when transferring interests in family-controlled entities. Specifically, the proposal would create a new class of "disregarded restrictions" that are ignored when valuing such an interest. Disregarded restrictions would include certain liquidation restrictions, as well as a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. The proposal thus seeks to limit the use of a strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death, namely, the inclusion in governing documents of purported restrictions that do not reflect economic reality. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

[1430] Commentators have referred to this discounting as the "disappearing wealth" phenomenon: Wealth disappears from the transfer tax base even though no (or little) actual economic value is lost. See Mary Louise Fellows and William H. Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome," 30 *Stanford Law Review* 895 (1978); James Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 *Tax Law Review* (1995); Laura E. Cunningham, "Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP," 86 *Tax Notes* 1461 (2000).

Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir. 2001), provides a simple example of the creation of discounts shortly before death. Mrs. Church, who was the mother of the plaintiff and was suffering from a terminal illness, and her two children together formed a limited partnership. In exchange for limited partnership interests, Mrs. Church contributed to the partnership her interest in a Texas ranch (valued at $380,038) together with $1,087,710 in publicly traded securities, while her two children contributed their undivided interests in the ranch. A corporation owned equally by the two children was the general partner of the partnership. Two days after the formation of the partnership, Mrs. Church died. The District Court found that the date-of-death value of Mrs. Church's limited partnership interest was $617,591, despite the fact that Mrs. Church transferred assets to the partnership worth $1,467,748 just two days earlier. The court upheld a 58-percent discount based upon the noncontrolling and illiquid nature of Mrs. Church's limited partnership interest.

Some may argue that the proposal does not specify or adequately describe the liquidation restrictions that will be disregarded in valuing a transfer of a family-controlled entity or other key aspects of the proposal; therefore, it is difficult to assess whether the proposal would be effective. As described above, the proposal establishes new "disregarded restrictions" that would be ignored in valuing an interest in a family-controlled entity. The Treasury Department provides that "the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations."[1431] The proposal, however, does not describe the assumptions that would be specified in regulations. Without such information, it is difficult to determine how the proposal is intended to operate. In addition, the Treasury Department provides that "[d]isregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations."[1432] One could speculate that this regulatory standard is intended in part to address interpretive concerns that have arisen regarding the present-law exception for restrictions that are imposed or required to be imposed under State or Federal law. The proposal, however, does not provide information from which one could determine what such a regulatory standard might include or whether such a standard might also be intended to address other concerns.[1433]

Some also may argue that, even in the absence of the proposal, the Secretary has broad authority under section 2704(b)(4) to issue new regulations establishing restrictions that must be disregarded in valuing transfers of an interest in a family-controlled entity; the proposal, under which many important details are left to regulations, arguably adds little to this present-law authority. The Tax Court in *Kerr v. Commissioner* stated that it was "mindful that the Secretary has been vested with broad regulatory authority under section 2704(b)(4)," but concluded that the current Treasury regulations did not support the IRS's position in the case.[1434] This statement by the *Kerr* court suggests that the court believed that the Secretary already has the authority to issue new, more restrictive regulations under section 2704(b). Furthermore, the IRS and Treasury business plan for 2008-2009 described a plan to issue guidance under section 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership. The Treasury Department's explicit plan to issue new guidance under section 2704(b) arguably raises questions about whether a legislative modification of this section is premature or even necessary.

Because the proposal appears to target only marketability discounts arising from liquidation restrictions, some may argue that a broader approach would be preferable. If, for example, an entity whose interests are nonmarketable holds marketable assets, a marketability

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[1431] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (February 2010), p. 124.

[1432] *Ibid*.

[1433] The Treasury Department also provides that, in determining whether a restriction may be removed by a family member following a transfer, certain interests held by charities or others who are not family members would be deemed to be held by the family; these interests are not described in the proposal, but would be "identified in regulations." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (February 2010), p. 124.

[1434] 113 T.C. 449, 474 (1999).

discount for an interest in the entity results in the undervaluing of the interest if the owner has a controlling interest in the entity and can easily access the marketable assets. Some other proposals have sought to curb this practice by imposing "look through" rules under which a marketability discount generally is denied to the extent an entity holds marketable assets.[1435] These proposals would apply even in the absence of liquidation restrictions. If the Administration's fiscal year 2011 budget proposal were enacted, taxpayers might seek to take advantage of marketability discounts through structures that did not depend on liquidation restrictions.

Furthermore, because the proposal appears to target only marketability discounts, it would not directly address minority discounts that do not accurately reflect the economics of a transfer. Some other proposals have sought to address certain excessive minority discounts more directly through aggregation of certain interests when determining whether a transferred interest in an entity should be valued as a minority interest. In 2005, the staff of the Joint Committee on Taxation published a proposal that includes such aggregation rules. Under the basic aggregation rule of the staff proposal, the value for transfer tax purposes of an asset transferred by a donor or decedent generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor immediately before the transfer.[1436] Under a separate aggregation rule included in the proposal, if a donor or decedent did not own a controlling interest in an asset immediately before a transfer, but in the hands of the donee or heir, the transferred asset is part of a controlling interest, the transfer tax value of the transferred interest is a pro-rata share of the fair market value of the entire interest in the asset owned by the donee or heir after taking into account the gift or bequest.

Other proposals have addressed minority discounts through rules that attribute ownership among family members. Under one such approach, a minority discount would be denied in connection with the transfer of an interest where the transferee and members of the transferee's family together have control of the entity.[1437] Although the Administration's budget proposal considers family relationships in determining whether a restriction on liquidation could be removed for purposes of section 2704(b), it does not include a family attribution rule that addresses the inappropriate use of minority discounts where family members control an entity. Some may argue, however, that such a family attribution rule would be inappropriate, because it

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[1435] See, e.g., Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (January 27, 2005), pp. 396-404; Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (February 1999), p. 167; Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (February 2000), pp. 184-85; H.R. 436, *Certain Estate Tax Relief Act of 2009* (111th Cong., 1st Sess.).

[1436] The basic aggregation rule is similar to a proposal made by the Treasury Department in 1984 as part of a broad report on tax reform. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth, vol. 2, General Explanation of the Treasury Department Proposals* (November 1984), pp. 386-88. The 1984 proposal, however, based the value of transferred property on the transferor's highest level of ownership after taking into account prior gifts. This tracing of ownership backward through all gifts made by a transferor during his or her lifetime arguably would create administrative difficulties.

[1437] See, e.g., S. 3533, *Responsible Estate Tax Act* (111th Cong., 2d Sess.); H.R. 436, *Certain Estate Tax Relief Act of 2009* (111th Cong., 1st Sess.).

is not correct to assume that individuals always will cooperate with one another merely because they are related.

Prior Action

The proposal was contained in the President's budget proposals for fiscal years 2010 and 2011. Different proposals to reform transfer tax valuation discounts were included in the President's budget proposals for fiscal years 2000 and 2001.

4. Require minimum term for grantor retained annuity trusts ("GRATs")

Present Law

Valuation of certain transfers in trust

In the event of a lifetime transfer in trust to (or for the benefit of) a member of the transferor's family where the transferor or an applicable family member retains any interest in the trust, a special rule applies for purposes of determining the value of the transferor's gift.[1438] In general, the value of any retained interest that is not a "qualified interest" is treated as zero.[1439] Therefore, where a transferor retains an interest that is not a qualified interest, the entire amount transferred to the trust generally is treated as a gift by the transferor to the remainder beneficiaries, which gift is subject to transfer taxation.[1440] The value of a retained interest that is a qualified interest (and thus is deducted from the value of the property transferred to the trust to determine the gift to the remainder beneficiaries), on the other hand, is determined using rates and procedures described in the Code for valuing temporal interests in property.[1441]

For these purposes, the term "qualified interest" means: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (i.e., a qualified annuity interest); (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually) (i.e., a qualified unitrust interest); and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2) (i.e., a qualified remainder interest).[1442]

A qualified interest is valued under procedures described in section 7520 using tables prescribed by the Secretary of the Treasury and an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the Federal midterm interest rate in effect under

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[1438] Sec. 2702(a)(1).

[1439] Sec. 2702(a)(2)(A).

[1440] The special valuation rule does not apply in certain excepted situations, including: (1) where the transfer is not a completed gift; and (2) transfers to certain personal residence trusts. See sec. 2702(a)(3).

[1441] Sec. 2702(a)(2)(B); sec. 7520.

[1442] Sec. 2702(b).

section 1274(d)(1) for the month in which the valuation date falls. The tables and rates described in section 7520 assume that the assets in a trust will grow at a relatively modest rate.

Grantor retained annuity trusts

A GRAT generally is an irrevocable trust under which the grantor retains an annuity interest structured as a "qualified interest" under section 2702. The annuity interest must be an irrevocable right to receive a fixed amount at least annually.[1443] The trustee must be required to invade the principal of the trust in the event the income is insufficient to pay the qualified annuity.

Assuming the transfer of assets to the trust is treated as a completed gift for gift tax purposes, the gift to the remainder beneficiaries generally will be subject to gift tax as of the time of the initial transfer of assets to the trust. Therefore, the grantor will be required to use a portion of his or her gift tax exemption equal to − or, to the extent insufficient exemption remains, to pay gift tax on − the value of the remainder interest determined as of the time the grantor funds the trust. The annuity portion of a GRAT is valued using the procedures for valuing qualified interests outlined in section 7520 (described above). To value the remainder interest in a GRAT, the value of any qualified interest, as determined under section 7520, is subtracted from the value of the property transferred to the trust.

When the grantor's retained annuity interest expires, the trust assets are distributed to one or more remainder beneficiaries identified in the trust instrument. Because the value of the transferor's gift for gift tax purposes is determined at the time of the transfer, if trust property grows at a rate in excess of the growth rate assumed under section 7520, the excess appreciation generally will pass to the remainder beneficiaries without further gift tax consequences to the grantor. If, however, the grantor dies during the trust term, that portion of the trust necessary to satisfy the annuity amount will be included in the grantor's gross estate for estate tax purposes.[1444] Such inclusion generally results in the loss of the transfer tax benefit of using a GRAT.[1445]

Description of Proposal

The proposal requires that a GRAT have a minimum term of 10 years. The proposal also requires that the remainder interest of a GRAT have a value greater than zero and prohibits any decrease in the annuity during the GRAT term.

[1443] Treas. Reg. sec. 25.2702-3(b).

[1444] Sec. 2036.

[1445] To the extent a GRAT is structured as a grantor trust, the grantor is treated as owner of the trust and must include in determining his or her taxable income and credits those items of income, deductions, and credits of the portion of the trust deemed owned by the grantor.

Effective date.−The proposal is effective for trusts created after the date of enactment. We assume for purposes of this analysis that the proposal also would apply to transfers after the date of enactment to trusts created on or before the date of enactment.

Analysis

The valuation rates and tables prescribed by section 7520 often produce relative values of annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, taxpayers often use GRATs to make gifts of property with little or no transfer tax consequences, so long as the investment return on assets in the trust is greater than the rate of return assumed under section 7520 for purposes of valuing the lead and remainder interests. In such cases, the excess appreciation during the GRAT term generally escapes transfer tax.

In some cases, for example, taxpayers "zero out" a GRAT by structuring the trust so that the value of the annuity interest under section 7520 equals (or nearly equals) the entire value of the property transferred to the trust. Under this strategy, the value of the remainder interest (which is computed by subtracting the value of the annuity as determined under section 7520 from the value of the property transferred to the trust) − and hence the value of any gift that is subject to gift taxation − is deemed to be equal to or near zero. In reality, however, taxpayers often achieve returns on trust assets substantially in excess of the returns assumed under section 7520. Any such excess appreciation generally passes to the remainder beneficiaries without further transfer tax consequences.

Furthermore, the grantor may risk little under present law by funding a "zeroed out" GRAT with an aggressive portfolio, even where the trust assets do not perform well. If the trust yield merely equals the statutorily assumed return on trust assets, the trust principal will be returned to the grantor in the form of annuity payments. If the trust yield is less than the required annuity payments, the trustee will invade the principal of the trust, and the grantor will receive in satisfaction of his annuity interest the same property (e.g., securities or other income producing assets) used to fund the trust.[1446] In either case, although the grantor has failed to achieve a low- or no-gift tax transfer to remainder beneficiaries, the grantor has lost only the use of capital during the term of the trust.

Grantors often structure GRATs with relatively short terms, such as two years, to minimize the time that the assets are unavailable to the grantor and the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor's estate for estate tax purposes. Because GRATs carry little down-side risk, grantors frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the grantor's odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the grantor to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.

[1446] Where the grantor is treated as owner of the trust, the distribution to the grantor generally will not be treated as a recognition event. See Rev. Rul. 85-13, 1985-1 C.B. 184.

The budget proposal is designed to introduce additional down-side risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two-year) GRATs, a GRAT with a 10-year term would tie up the assets transferred to the GRAT for a longer term and would carry greater risk that the grantor would die during the trust term and that the trust assets would be included in the grantor's estate for estate tax purposes.[1447]

The proposal would eliminate the use of shorter-term GRATs (i.e., GRATs with terms of less than 10 years) for gift tax avoidance. It is likely, however, that some taxpayers would continue to use GRATs with terms of 10 or more years as a gift tax avoidance tool. Even in the absence of a statutory minimum term, the use of a longer-term GRAT may be more desirable than using successive shorter term GRATs in certain circumstances, such as where the section 7520 rate is expected to increase over time. In this situation, use of a longer-term GRAT would allow the grantor to lock in the lower rate for the entire trust term. The proposal arguably would do little to curb the use of GRATs in such cases.

Commentators also have noted that the proposal would make it more difficult for taxpayers who establish GRATs to "capture upside volatility," which is the principal feature of a GRAT that provides for the transfer of additional wealth to heirs without further transfer tax consequences.[1448] While noting that the current economic climate has caused some taxpayers to lengthen GRAT terms beyond two years in any event, the commentators note that "*requiring* a minimum ten-year term would encourage more customizing of the terms of a GRAT, including greater use of level GRATs or GRATs in which the annuity increases in some years but not others or increases at different rates in different years."[1449]

The proposal would not prevent the "zeroing-out" of a GRAT's remainder interest for gift tax purposes or the funding of GRATs with an aggressive portfolio. Instead, the proposal introduces downside risk only by increasing the likelihood that a grantor will die during the trust term. Wealthy younger taxpayers may view the likelihood of dying during a 10-year trust term as remote and thus may be willing to establish one or more 10-year GRATs in an effort to avoid gift tax. The proposal might therefore have the effect of encouraging taxpayers to establish GRATs earlier in life. Long-term GRATs likely would be less attractive to taxpayers who achieve wealth only at a more advanced age.

Some might argue that a better approach would be one that achieves a more accurate valuation of the gift portion of a GRAT for gift tax purposes. This could be achieved, for example, by deferring the valuation of the remainder interest until it is distributed. Valuing the actual assets that will pass to the remainder beneficiaries at the time of the distribution, and

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[1447] The proposal also requires that the remainder interest of a GRAT have a fair market value greater than zero and prohibits a reduction in the annuity during the GRAT term. These requirements are designed to prohibit circumvention of the ten-year minimum term requirement of the proposal.

[1448] See Dennis I. Belcher, Samuel A. Donaldson, Beth Shapiro Kaufman, et al., "Recent Developments−2010," p. 14, presented at 45th Annual Heckerling Institute on Estate Planning (January 2011).

[1449] *Ibid*. (emphasis in original).

basing the amount of the grantor's gift tax on such valuation, largely would eliminate opportunities to use a GRAT to leverage a gift tax exemption or, in the case of a "zeroed out" trust, to pass assets to heirs free of gift tax. On the other hand, some might argue that such an approach would introduce uncertainty into transfer tax planning. For example, in certain instances a grantor may not be able to predict the extent of appreciation of trust assets that will occur during the annuity term. This lack of certainty, one might argue, could result in unexpected taxable gifts by the grantor, and the grantor may have insufficient liquid assets to pay an unexpected gift tax when due.[1450] Deferring valuation of the remainder interest also might create administrative challenges for the IRS; although a gift tax return is filed for the year in which assets are transferred to the trust, the value for gift tax purposes would not be determined until the interest is distributed, which could occur many years later.

Prior Action

A substantially identical proposal was included in the President's budget proposals for fiscal years 2010 and 2011. A provision based on the prior-year proposals was passed by the U.S. House of Representatives as part of the "Small Business Infrastructure Jobs Tax Act of 2010,"[1451] the "Small Business Jobs Tax Relief Act of 2010,"[1452] and H.R. 4899,[1453] but was not enacted.

5. Limit duration of generation skipping transfer ("GST") tax exemption

Present Law

Generation-skipping transfer tax rules

In general

Present law generally imposes transfer taxes designed to tax transfers of wealth once each generation. Taxes on transfers are imposed in the form of gift tax on lifetime transfers, estate tax on transfers at death, and a generation skipping transfer tax on gifts and bequests made to persons more than one generation younger than the transferor. A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person".[1454] Transfers subject to the generation skipping transfer tax include direct skips, taxable

[1450] Such uncertainty could be addressed, however, though an election under which a grantor agrees to have trust assets invested only in certain less aggressive instruments likely to produce an average return not greater than the return assumed under section 7520. This would limit a grantor's ability to manipulate the GRAT valuation assumptions to pass assets to heirs free of gift tax.

[1451] See sec. 307 of H.R. 4849 (111th Cong., 2d Sess.), passed by the U.S. House of Representatives on March 25, 2010.

[1452] See sec. 531 of H.R. 5486 (111th Cong. 2d Sess.), passed by the U.S. House of Representatives on June 15, 2010.

[1453] See H.R. 4899 (111th Cong., 2d Sess.), passed by the U.S. House of Representatives on July 1, 2010.

[1454] Sec. 2601.

terminations, and taxable distributions.[1455] An exemption generally equal to the estate tax applicable exclusion amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

The transferor is generally the individual who transfers property in a transaction that is subject to Federal estate or gift tax. A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.[1456] Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.[1457] A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).[1458] If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The generation skipping transfer tax generally does not apply to lifetime gifts of a present interest in property up to the annual exclusion amount,[1459] or for certain transfers for educational or medical expenses. A transferor is entitled to a generation skipping transfer tax exemption, equal to the estate tax applicable exclusion amount, which may be allocated to transfers made by the transferor either during the transferor's life or at death. The generation skipping transfer exemption amount for 2009 was $3.5 million. The exemption amount was increased to $5 million (indexed for inflation after 2011) under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Extension Act").[1460] The exemption amount reverts to the pre-EGTRRA amount $1 million for transfers after December 31, 2012.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The maximum estate and gift tax rate for 2009 was 45 percent. The generation skipping transfer tax rate was zero for generation skipping transfers in 2010. The maximum estate and gift tax rates

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[1455] Sec. 2611.

[1456] Sec. 2612(c).

[1457] Sec. 2612(a).

[1458] Sec. 2612(b).

[1459] For 2011, the annual exclusion amount is $13,000.

[1460] Pub. L. No. 11-312, signed into law December 17, 2010. The Act extended the sunset provisions of EGTRRA through December 31, 2012.

were decreased to 35 percent under the 2010 Extension Act. The maximum estate and gift tax rate reverts to the pre-EGTRRA rate of 55 percent for transfers after December 31, 2012.

The inclusion ratio with respect to any property transferred in a generation skipping transfer is a function of the amount of "generation skipping transfer tax exemption" allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer. The inclusion ratio is defined as one minus the applicable fraction.[1461] The applicable fraction is a fraction the numerator of which is the generation skipping transfer tax exemption allocated to the trust (or the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip) reduced by Federal and State estate and death taxes attributable to such property actually recovered from the trust (or transferred property) and any charitable deduction allowed for Federal estate and gift tax on the transfer.

In the case of a generation skipping transfer trust, the exemption applies to distributions from, or terminations of interests in, that fraction of the trust that the portion of the exemption that is allocated to the trust bears to the value of trust's assets at its creation. Thus, if a generation skipping transfer trust is created in 2011 with $5 million and $5 million of the transferor's generation skipping transfer exemption is allocated to that trust, the inclusion ratio is zero, and no generation skipping transfer tax is imposed on distributions from, or taxable terminations of interests in, that trust regardless of the number of generations of the trust's beneficiaries that are skipped. Alternatively if none of the transferor's generation skipping transfer tax exemption is allocated to the trust, the inclusion ratio is one, and generation skipping transfer tax at the maximum rate is imposed on taxable distributions and taxable terminations.

If an individual makes a direct skip during his or her lifetime, any unused generation skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

[1461] Sec. 2642.

Modifications to the generation skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property. An individual can elect out of the automatic allocation or may elect to treat a trust as a generation skipping transfer trust attracting the automatic allocation.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor's grandparent predeceases the transferor, then the transferor can allocate any unused generation skipping transfer tax exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining the amount of generation skipping transfer tax exemption needed to produce a zero inclusion ratio.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

The estate, gift, and generation skipping transfer tax provisions of EGTRRA, as modified by the Extension Act of 2010, sunset at the end of 2012, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012. As a result, the EGTRRA modifications to the generation skipping transfer tax rules described above will not apply to generation skipping transfers made after December 31, 2012. Instead, in general, the rules as in effect prior to 2001 will apply.

Special Generation Skipping Transfer Tax Trust Rules

The generation skipping transfer tax provisions include special rules for various transfers to and from certain trusts. One such rule requires that the portions of a trust attributable to transfers from different transferors to be treated as separate trusts.[1462] Distributions or terminations from such trusts are treated as occurring pro rata from each portion, unless the trustee separates the shares into two separate trusts as provided in the regulations.

Another rule addresses the taxation of multiple skips. This rule provides that where there is a generation skipping transfer and the property is held in trust, for purposes of applying the generation skipping transfer tax to subsequent transfers, the trust will be treated as if the transferor were assigned to the first generation above the highest generation of any person with an interest in the trust after the transfer.[1463] This is often referred to as the "move-down" rule. A special move-down rule applies to property transferred from one trust to another trust (a "pour-over trust"). This rule requires the inclusion ratio for the pour-over trust to be adjusted by treating the non-tax portion of the transferred property as if it were generation skipping transfer exemption allocated to the trust.

Rule against perpetuities

Many States limit the length of time that assets can be held in trust for the benefit of beneficiaries who were not alive at the time of the creation of the trust. This limitation is generally referred to as the rule against perpetuities. The rule against perpetuities was a judicially created rule of English common law. In many cases, States adopted the Uniform Statutory Rule Against Perpetuities. Under the uniform statute, "trust settlors may elect to create either a trust measured by lives in being at the creation of the trust plus 21 years or trust measured by ninety-years."[1464]

Over the past three decades several States have repealed the rule against perpetuities for trusts. Several others provide provisions allowing transferors to opt-out of the rule. Other States have modified the rule to permit trusts to remain in existence far past the 90 years imposed under

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[1462] Sec. 2654(b).

[1463] Sec. 2653.

[1464] Jesse Dukeminier, "The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities," *Real Property Probate & Trust Journal*, 30 (1995), p. 185.

the uniform rule against perpetuities.[1465] In such States, it is possible to transfer assets to a trust to which the transferor's generation skipping tax exemption has been allocated. The trust assets may grow for a potentially unlimited period of time without being subject to any transfer tax. Because of their potential long life and potential for substantial accumulation, such trusts generally are called "perpetual dynasty trusts."

Description of Proposal

The proposal provides that, on the 90th anniversary of the creation of a trust, the generation skipping transfer exclusion allocated to the trust terminates. Specifically, this is achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from generation skipping transfer tax. Because contributions to a trust from a different grantor are deemed to be held in a separate trust under section 2654(b), each such separate trust is subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust.

Under the proposal, the special rule for pour-over trusts under section 2653(b)(2) is still applicable to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts will be deemed to have the same date of creation as the initial trust, with one exception, as follows. If, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as described in section 2642(c)(2), the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary's distribution to continue to be held in trust without incurring generation skipping transfer tax on distributions to the beneficiary as long as that trust is used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary's death is included in the beneficiary's gross estate for Federal estate tax purposes.

The other rules of section 2653 continue to apply under the proposal, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority is included in the proposal to facilitate the implementation and administration of this proposal.

Effective date.−The proposal is effective for trusts created after the date of enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after the date of enactment (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the generation skipping transfer tax).

Analysis

As discussed above, many States have now either repealed or limited the application of their rule against perpetuities, with the effect that trusts created subject to the laws of those

[1465] For a summary of State perpetuities statutes see Richard W. Nemo, "Perpetual Dynasty Trusts: Tax Planning and Jurisdiction Selection," *ALI-ABA Course of Study*, SS010-253 (November 2010), Appendix D.

jurisdictions may continue in perpetuity. A trust may be sitused anywhere; a grantor is not limited to the jurisdiction of the grantor's domicile for purposes of establishing a trust. The Administration believes, that as a result, the transfer tax shield provided by the generation skipping transfer exemption effectively has been expanded from trusts funded with $1 million and a maximum duration limited by State rules against perpetuities, to trusts funded with $5 million and continuing (and growing) in perpetuity. Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation.

As Congress stated both when it originally imposed a tax on generation skipping transfers in 1976 and again when it revised the generation skipping transfer tax in 1986, the purpose of imposing gift, estate and generation skipping tax was "not only to raise revenue, but to do so in a manner that has as nearly as possible a uniform effect."[1466] Similarly, the Congress stated that it "believed that the tax law should basically be neutral and that there should be no tax advantage available in setting up trusts."[1467] The imposition of a generation skipping tax was believed necessary to achieve the uniformity of imposing a transfer tax once every generation. A $1 million exemption from the generation skipping tax originally was provided when the generation skipping tax was revised in 1986. The size of the generation skipping transfer tax exemption was increased beginning in 2002 to be equal to the amount of the applicable exclusion amount for estate and gift taxes. When Congress originally enacted a tax on generation skipping transfers, it noted that "[m]ost States have a rule against perpetuities which limits the duration of a trust."[1468]

With the softening of many State's rules against perpetuities and the increase in the generation skipping transfer tax exclusion amount, it is possible to transfer assets and allocate up to $5 million of exemption to trusts without limitation on the duration of the trust's life. Potentially unlimited growth in the trust assets may occur, while the assets are not subject to any transfer tax even though the trust's assets have benefited many generations. These perpetual dynasty trusts can be used to frustrate the uniform application of transfer tax that was envisioned when the generation skipping tax was enacted.

Some may argue that the proposal results in greater uniformity in the application of the generation skipping transfer tax by requiring the termination of the generation skipping transfer exclusion allocated to the trust on the 90th anniversary of the trust's creation. This termination would result in the trust having an inclusion ratio of one, and all subsequent generation skipping transfers (taxable distributions and terminations) from the trust would be subject to generation skipping transfer tax. Ninety years may be viewed as an arbitrary limitation on the exclusion from generation skipping transfer taxes on assets placed in trusts. Such a limitation would

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[1466] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 1263.

[1467] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), December 29, 1976, p. 565.

[1468] *Ibid.*

impose tax on distributions to grandchildren made after the 90th year. On the other hand, any attempt to fix the termination of the exclusion directly to the lives of the second generation below the transferor would add significant complexity to the proposal and it could be argued that the 90-year limitation lines up with the uniform statutory rule against perpetuities.

The proposal may be viewed as consistent both with the purpose of enacting a generation skipping transfer tax, and with the operation of the present transfer tax system, which generally imposes a tax once every generation by limiting the amount of assets that can be excluded from the present-law transfer taxes. The proposal also is consistent with the generation skipping tax exemption, in that it permits an exemption from the generation skipping transfer tax for transfers to the transferor's grandchildren. In addition, the proposal is consistent with the purposes of the rule against perpetuities to prevent perpetuation of wealth disparities, promote alienability of property, and make property productive.[1469] The proposal does not prevent an individual from creating a trust in a State that has repealed the rule against perpetuities; nor does it result in the termination of the trust. Thus, the proposal does not prevent the creation of a trust in a State if that State otherwise would be the best State in which to create a trust. The proposal does, however, eliminate a Federal transfer tax advantage for creating a trust in a State that has repealed the rule against perpetuities.

Some may argue that the proposal adds complexity to what is already a complex area of transfer tax law, including requiring grandfather rules to track additions to trusts created prior to the date of enactment. Under the proposal, a trustee would be required to know the anniversary date and understand the implications of the 90-year rule even though many of the persons involved in the creation and setup of the trust are no longer living. It could be argued that such a limitation is a trap for trustees who make distributions in the future without realizing that the taxable status of the trust suddenly changed. On the other hand, it could be argued that the proposal simplifies existing law by providing a bright-line rule for determining the duration of the generation skipping trust exemption allocated to the trust. This bright-line rule is arguably simpler than identifying the trust's termination date under existing rule against perpetuities laws. An alternative to eliminate or limit the use of dynasty trusts would be to prohibit any allocation of generation skipping tax exclusion to trusts if such trusts could benefit generations other than the transferor's children or grandchildren.[1470] Such a proposal would require a determination of who could benefit from the trust, which may be difficult particularly where the trust instrument allows for discretionary distributions or special powers of appointment.

Prior Action

No prior action.

[1469] Brian Layman, "Comment: Perpetual Dynasty Trusts: One of the Most Powerful Tools in the Estate Planner's Arsenal," *Akron Law Review*, 32 (1999), p. 747.

[1470] For one such proposal, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 392.

PART IX − UPPER-INCOME TAX PROVISIONS

A. Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability

Present Law

General structure of the individual income tax

Under the Code, gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include, among other things, trade or business expenses, contributions to pensions and other retirement plans, certain moving expenses, and alimony payments.

To determine 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 2011, the amount deductible for each personal exemption is $3,700. This amount is indexed annually for inflation. For 2011, the deduction for personal exemptions is not reduced or eliminated based on income. Prior to 2010, deductions for personal exemptions were reduced when income exceeded certain thresholds, which were adjusted annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. (The phase-out rate was two percent for each $1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed was phased-out over a $122,500 range (which was not indexed for inflation), beginning at the applicable threshold. In 2009, those thresholds were $166,800 for single individuals, $250,200 for married individuals filing a joint return and surviving spouses, $208,500 for heads of households, and $125,100 for married individuals filing separate returns. The limitation on personal exemptions is fully effective again in 2013 and thereafter as a result of the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") sunset provision.

Standard and itemized deductions

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2011, the amount of the standard deduction is $5,800 for single individuals and married individuals filing separate returns, $8,500 for heads of households, and $11,600 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.[1471] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

[1471] For 2011, the additional amount is $1,150 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,450. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2011) of $2,300 or $2,900, as applicable.

In lieu of taking the applicable standard deductions, 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 7.5 percent of AGI), casualty and theft losses (in excess of $500 per loss and in excess of 10 percent of AGI), and certain miscellaneous expenses (in excess of two percent of AGI).

For 2009, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by the lesser of three percent of the amount of the taxpayer's AGI in excess of $166,800 ($83,400 for married couples filing separate returns) or 80 percent of such deductions. These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present law limitations applicable to such deductions (such as the separate floors) are applied first, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. For taxable years beginning after 2005 and before 2010, the overall reduction in itemized deductions was phased down to 2/3 of the full reduction amount in 2006 and 2007, and 1/3 of the full reduction amount in 2008 and 2009. In 2011 and 2012, the phase-out of itemized deductions does not apply. However, the limitation on itemized deductions is fully effective again in 2013 and thereafter as a result of the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") sunset provision.

Individual income tax rates

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains and qualified dividends, and those rates apply for both the regular tax and the alternative minimum tax.

To determine regular tax liability, a 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. Separate rate schedules apply based on an individual's filing status. For 2011 the regular individual income tax rate schedules are listed earlier in section XIII.C of this document.

Alternative minimum tax liability

An alternative minimum tax ("AMT") is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and qualified dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the

taxpayer's "tax preference items" and adjusted by redetermining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2011 are: (1) $74,450 in the case of married individuals filing a joint return and surviving spouses; (2) $48,450 in the case of other unmarried individuals; (3) $37,225 in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions items, are not allowed to reduce AMTI.

Description of Proposal

The proposal would limit the rate at which taxpayers benefit from itemized deductions. In general, the proposal limits the benefit of itemized deductions for individuals to 28 percent of the amount of the deductions. The proposal would apply to itemized deductions after they have been reduced under a separate fiscal year 2012 budget proposal that would reinstate the pre-EGTRRA limitation on certain itemized deductions, as discussed in Part XIII.D. In 2012, the limitation would affect itemized deductions that would otherwise reduce taxable income in the 35 percent bracket and a protion of the 33 percent bracket. For 2013 and beyond, the limitation would affect itemized dedecutions that would otherwise reduce taxable income in the 36 or 39.6 percent tax brackets.

Example 1: Taxpayer subject to regular income tax

Assume that a taxpayer in the 35-percent income tax bracket for 2012 makes a $10,000 charitable contribution. Under present law, the $10,000 contribution will result in a $3,500 tax savings, or 35 percent of $10,000 (disregarding any other limitations that may apply to reduce the taxpayer's itemized deductions). Under the proposal, the same $10,000 contribution by the same 35-percent bracket taxpayer would result in a tax savings of only $2,800 (28 percent of $10,000), thus raising his tax liability by $700 (or seven percent (35 percent minus 28 percent) of his $10,000 contribution).

Example 2: Taxpayer subject to alternative minimum tax

The proposal would have two effects on taxpayers subject to the AMT. However, these effects apply only if the taxpayer is first subject to any reduction in his regular tax liability−that is, if his marginal statutory regular tax rate is in excess of 28 percent.

Under the first effect, the proposal increases the taxpayer's tentative minimum tax liability by a fraction of the increase in regular tax liability caused by the limitation. The fraction is equal to the proportion of non-preference item itemized deductions to total itemized deductions. Thus, in the example above, assume the taxpayer had $20,000 in State and local taxes, an itemized deduction that is a preference item for purposes of the AMT, in addition to his $10,000 charitable deduction (a non-preference item), for a total of $30,000 of itemized deductions. Under the regular tax, the taxpayer will have his tax liability increased by seven percent (35 percent minus 28 percent) of $30,000, or $2,100. The taxpayer's tentative minimum tax liability is increased by $2,100 times the fraction of non-preference to total itemized deductions ($10,000/$30,000, or 1/3), or $700.

The second effect is triggered if the taxpayer's AMTI is in the range that makes him subject to the phase-out of the AMT exemption amount. In this situation, the taxpayer is subject to an additional increase in his tentative minimum tax liability. The additional increase is equal to the amount by which the value of the non-preference itemized deductions exceeds 28 percent of the deduction. For example, if the taxpayer is in the 28 percent marginal rate bracket of the AMT, but is also subject to the phase-out of the AMT exemption amount, a non-preference itemized deduction reduces his AMT liability in two ways under present law. First, the direct effect is that the deduction lowers AMTI by the amount of the deduction, reducing the tax liability by 28 percent of the deduction amount. Second, in reducing AMTI directly, the deduction reduces the phase-out of the AMT exemption amount by 25 percent of the deduction amount. Thus, the combined effect of the deduction under present law is to reduce AMTI by 125 percent of the deduction, which, for the 28 percent ratepayer, reduces AMT liability by 125 percent of 28 percent, or 35 percent of the deduction amount. Under the proposal, the value of the deduction would be limited to 28 percent of the deduction amount, thus a taxpayer subject to the AMT exemption amount phase-out will face a further increase in his AMT liability, in this case equaling seven percent of the deduction amount.[1472] For the taxpayer described above with $10,000 of non-preference deductions, the taxpayer's tentative minimum tax liability would be increased a further $700 (seven percent of $10,000).

Effective date.−The proposal is effective for tax years beginning after December 31, 2011.

[1472] In the case of a taxpayer subject to the AMT exemption phaseout but in the statutory 26 percent AMT rate bracket, the value of a non-preference item is 125 percent of 26 percent, or 32.5 percent. Such taxpayer will face an increase in their AMT liability of 4.5 percent (32.5 - 28) of the amount of the deduction by this second effect of the proposal.

Analysis

In general

This proposal has been the subject of considerable debate. Although the proposal applies broadly to all itemized deductions, much of the debate centers on the likely effect of the proposal on charitable giving and housing (discussed below). Some proponents have argued that limiting the benefit of itemized deductions in this manner will reduce the incentive to undertake certain activities. To the extent that certain deductions, such as those for medical expenses, casualty or theft losses, or local taxes, are designed to more accurately reflect a taxpayer's ability to pay, opponents argue that no adjustment should be made to the deductions, and any concern about fairness or progressivity should be addressed through the marginal tax rate structure.

Alternative minimum tax

The proposal impacts taxpayers subject to the AMT more substantially than taxpayers not subject to the AMT. Specifically, the proposal reduces the value of the taxpayer's itemized deductions to an amount less than 28 percent, as a result of the two effects described in example two above. In that example, because the taxpayer's aggregate liability is determined by the AMT (since that yields a higher tax than the regular tax), the taxpayer's regular tax liability is not relevant as it is below his AMT liability.[1473] Under the proposal, notwithstanding that the taxpayer is subject to the AMT, an additional increase in AMT liability is imposed based on the regular tax computation even though that computation ordinarily would have no bearing on AMT liability. In the example, under present law the taxpayer will receive a $3,500 tax benefit from his $10,000 charitable contribution, composed of the deduction against the 28 percent marginal AMT rate (yielding $2,800) and the reduction in the amount of the phaseout of the exemption amount (25 percent of 10,000 = $2,500), whose value at the 28 percent rate is 28 percent of $2,500, or $700. Under the proposal, the taxpayer loses this $700 benefit related to the phaseout of the exemption amount, and is also subject to the $700 increase in tax based on the first of the AMT effects described above (related to the reduction in the value of the itemized deductions as calculated for the regular tax). On net, the taxpayer receives only a $2,100 benefit for the $10,000 deduction. Thus, the value of his charitable deduction is held to 21 percent, not 28 percent.[1474]

It is not clear on what policy grounds the proposal imposes the first of these effects on AMT taxpayers, as the second effect is sufficient to limit the value of the deductions to 28

[1473] While technically a taxpayer's AMT liability is tax imposed in addition to regular tax liability, the term "AMT liability" is used in this discussion, for ease of exposition, to refer to the aggregate tax liability of a taxpayer affected by the AMT.

[1474] In the event that the taxpayer were in the 35 percent regular tax bracket but subject to the AMT as well as the phaseout of the AMT exemption amount, the $10,000 charitable deduction will trigger an increase in the AMT of $700 by the first effect (35 percent - 28 percent multiplied by $10,000), and a further $700 by the second effect as described above, yielding a deduction value of only $2,100 ($3,500 - $700 - $700). Such taxpayer's charitable contribution deductions are thus limited to 21 percent of the deduction amount, rather than the proposal's asserted 28 percent.

percent of the deduction. By imposing an additional tax liability on AMT taxpayers based on an increase in their regular tax that still leaves their regular tax liability below their AMT liability is a departure from the normal relationship between the regular tax and the AMT. Under the normal relationship between the AMT and the regular tax, any increase in one's regular tax liability that occurs as result of any provision of the Code will increase one's overall tax liability only if regular tax liability exceeds AMT liability.

Charitable deduction

Some argue that the proposed limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions by increasing the after-tax cost of charitable giving.[1475] Additionally, the reduction in after-tax income resulting from the proposal will mean that taxpayers have less disposable income to spend on all goods, including charity. These commentators argue that the proposal will result in a decrease in charitable giving as a result of both the increased after-tax cost of charitable giving and the reduction in after-tax income.[1476] With respect to the altered after-tax cost of giving, for example, under present law a 35-percent bracket taxpayer who makes a $1,000 charitable contribution (disregarding any other limitations that may apply to limit itemized deductions) will save $350 in Federal income tax (35 percent of $1,000). In other words, the after-tax cost to the taxpayer is only $650 to give $1,000 to charity ($1,000 - $350 savings). Under the proposal, that $1,000 charitable contribution will cost the same taxpayer $720 ($1,000 - (28 percent of $1,000)). This represents a cost increase of more than 11 percent.

Others, however, argue that the proposed limit will result in little if any reduction in overall charitable giving.[1477] Some argue, for example, that charitable giving is motivated in significant part by factors other than tax rules, such as altruism and the overall state of the

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[1475] For a recent literature review of the responsiveness of charitable giving to its price, see John Peloza and Piers Steele, "The Price Elasticities of Charitable Contributions: A Meta Analysis," 24 *Journal of Public Policy & Marketing*, pp. 260-272, (2005). See also Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* Chicago: University of Chicago Press (1985); and Jon Bakija and Bradley Heim "How Does Charitable Giving Respond To Incentives And Income? Dynamic Panel Estimates Accounting For Predictable Changes In Taxation," National Bureau of Economic Research Working Paper 14237 (August 2008).

[1476] See Independent Sector, Statement on Changes to Tax Incentives for Charitable Giving and Health Care Reform, *http://www.independentsector.org/media/20090326_giving_healthcare_statement.html* (March 26, 2009) (arguing that changes in tax benefits affect charitable giving levels and that the President's budget proposal will result in a decrease in charitable giving).

[1477] For example, the Center on Philanthropy at Indiana University performed a study to determine how the President's proposal would affect charitable giving. See The Center on Philanthropy at Indiana University, White Paper, "How Changes in Tax Rates Might Affect Itemized Charitable Deductions," *available at http://www.philanthropy.iupui.edu/docs/2009/2009_TaxChangeProposal_WhitePaper.pdf* (March 2009) (hereafter "Indiana University White Paper"). Using a simplified model and 2006 itemized deduction data, the Center estimated that, if the budget proposal had been in effect in 2006, "the impact on itemized giving would have been a relatively small reduction when measured as a percentage of total itemized charitable giving by individuals (a decrease of 2.1 percent)." Looking only at the highest income households, the Center estimated a slightly larger drop (approximately 4.8 percent). The Center concluded that "[t]he larger economy plays a more important role in changes in giving than do tax rate changes."

economy;[1478] most taxpayers, therefore will not eliminate or significantly reduce charitable giving under the proposal. Indeed, under the proposal, each additional dollar given to charity by a taxpayer subject to the proposal will continue to result in a tax savings, although at a rate of 28 percent rather than the higher 33 or 35-percent rates.

Furthermore, some argue that the proposal improves fairness and equity to the tax treatment of itemized deductions by partially leveling the tax benefit to higher- and lower-income taxpayers resulting from identical gifts. For example, assume that a taxpayer in the 35-percent bracket and a taxpayer in the 25-percent bracket each make identical $1,000 contributions to charity. As a result of the $1,000 contribution, the higher-income taxpayer will have a tax savings of $350 (35 percent of $1,000), such that his cost of making the $1,000 contribution is $650 ($1,000 - $350). The taxpayer in the 25-percent bracket, however, will achieve a tax savings of only $250 (25 percent of $1,000), such that his cost of making the $1,000 contribution is $750 ($1,000 - $250). In other words, under present law, an identical charitable contribution results in a greater tax benefit (in this example, $100) to the higher-bracket taxpayer, even though the lower-bracket taxpayer arguably has been more generous by contributing a higher percentage of his taxable income to charity. The proposal limits (but does not eliminate) this disparate treatment by limiting the rate at which the higher-bracket taxpayer may benefit from itemized deductions to 28 percent.[1479]

On the other hand, such a fairness argument rests on an implicit assumption that, when a taxpayer makes a charitable contribution, he or she is buying something that yields personal gain. If, however, one's initial view is that a gift to charity reduces a taxpayer's resources available for private consumption, then the proposed modification to the marginal rates at which taxpayers may benefit from deductions should not be undertaken. Under this view, a taxpayer with a $110,000 in income who gives $10,000 to charity is in the same economic position as someone who earns $100,000 and donates nothing to charity, and thus the full deduction should be allowed at the taxpayer's statutory marginal tax rate. Otherwise, taxpayers similarly situated with respect to resources available for private consumption would face differential tax burdens.

Mortgage interest and property tax deductions

The deductions for home mortgage interest and property taxes reduce the after-tax cost of financing and maintaining a home. The benefit for any given dollar amount of deduction rises as the marginal tax rate of the taxpayer rises. However, research suggests that the aggregate benefits of the home mortgage interest deduction, and thus the costs of any limitation, are distributed heterogeneously among taxpayers, even among those with more than $250,000 in income.[1480] Within this group, as within any group, the largest benefits accrue to younger

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[1478] See, e.g., Indiana University White Paper, *supra*.

[1479] Note that this disparate treatment would not exist if all taxpayers faced the same marginal tax rate. In other words, the disparate treatment is the combined effect of the deduction and a progressive rate (or any non single rate) structure.

[1480] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96 (May 2008).

homeowners, who tend to have higher loan-to-value ratios, and to those taxpayers purchasing more expensive homes.

Limiting itemized deductions will increase the after-tax cost of financing and maintaining a home for affected taxpayers. One study estimates that completely repealing the mortgage interest deduction will increase the cost of capital for owner-occupied housing by seven percent.[1481] Smaller cost increases are associated with limiting the deduction. However, if in response to limiting the mortgage interest deduction, taxpayers adjusted their portfolios by liquidating non-housing assets to reduce their mortgage debt, changing the tax treatment of mortgage interest might have little impact on the cost of capital for owner-occupied housing.[1482] As with the benefits of the deduction, the largest increases in the cost of housing will occur for younger, high-income homeowners with relatively higher loan-to-value ratios and relatively fewer non-housing assets with which to reduce those ratios. Under general economic principles, demand for housing by affected taxpayers would be expected to decline in response to the increased cost.

Some argue that the proposal will have a detrimental effect on the U.S. economy, because it will lead to a decline in home prices at a time when many homeowners have already seen the value of their residences decline to an amount below their mortgage balances. Areas with relatively large numbers of affected taxpayers and relatively inelastic housing supply will be expected to face the greatest price declines. This, they argue, could lead to deterioration in bank balance sheets as the value of their mortgage loans and mortgage-backed securities also decline.

Others argue that limiting the home mortgage interest deduction is unlikely to have a detrimental effect on the U.S. economy. They argue that the limitation will affect too few taxpayers to reduce incentives for the marginal homebuyer, and thus home prices would not likely decline. Still others question whether the mortgage interest deduction even serves its intended purpose of encouraging homeownership and the positive spillover benefits presumed to entail.[1483] On the contrary, proponents argue that, to the extent that the mortgage interest deduction creates economic distortions − increasing the size and cost of housing, increasing the allocation of capital to owner-occupied housing away from potentially higher pre-tax return investments in other sectors, increasing the amount of leverage used to purchase homes −

[1481] *Ibid.*

[1482] See Martin Gervais and Manish Pandey, "Who Cares about Mortgage Interest Deductibility?" *Canadian Public Policy,* vol. 34, March 2008, available at http://www.economics.soton.ac.uk/staff/gervais/publications/gervais_pandey_cpp_2008.pdf. Wealthier households are more likely to alter their balance sheets to reduce their loan-to-value ratios. To the extent that non-housing assets generate income subject to tax, such portfolio shifting will reduce taxable income for these households, partially offsetting the increase in tax due to limitation of the deduction. Also, the benefits of deductibility do not increase with income as fast as taxes paid. Accordingly, Gervais and Pandey (2008) find "mortgage interest deductibility makes the tax code less progressive at relatively low levels of income and more progressive for relatively high levels of income."

[1483] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction" in James M. Poterba (ed.), *Tax Policy and the Economy* 17, Cambridge, Mass.: The MIT Press (2003).

limiting the deduction could be beneficial to the economy as a whole by minimizing such distortions.

Prior Action

A similar provision was included in the President's fiscal year 2010 and 2011 budget proposals.

PART X − USER FEES

A. Reform Inland Waterways Funding

Present Law

The Code imposes a tax of 20 cents per gallon on fuel used in a vessel in commercial waterway transportation to fund the Inland Waterways Trust Fund.[1484] Commercial waterway transportation means any use of a vessel on any inland or intracoastal waterway of the United States in the business of transporting property for compensation or hire, or in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage).

The Code provides several exemptions from the tax. The tax does not apply to fuel for vessels primarily used for passenger transportation. Nor does it apply to fuel used in deep-draft ocean-going vessels. Additional exemptions are provided for fuels used by State and local governments in transporting property in governmental business and for fuels used by tugs moving LASH (lighter-aboard-ships) and seabee oceangoing barges released by their oceangoing carriers solely to pick up or deliver international cargoes.

In addition to tax revenues, the Inland Waterways Trust Fund also earns investment interest on its unexpended balances. In fiscal year 2010, $73.9 million was collected from the inland waterway fuel tax and the trust fund earned $0.1 million in interest.[1485] At the end of fiscal year 2010, the trust fund had a balance of $58.5 million. However, the balance available for new obligations is $36.6 million.[1486]

The Army Corps of Engineers is responsible for the construction, operation and maintenance of inland waterway infrastructure. Present law allows up to 50 percent of the cost of construction projects to be funded by the Inland Waterway Trust Fund, the remainder to be funded from general revenues.

Description of Proposal

The tax on liquids used as a fuel in a vessel in commercial waterway transportation is phased out and replaced by a fee system based on lock usage. The tax rate is reduced to 10 cents per gallon beginning January 1, 2014. The tax is repealed for periods after December 31, 2015.

[1484] Sec. 4042(b) and sec. 9506. In addition to the 20-cents-per-gallon Inland Waterways Trust Fund financing rate, such fuel is also subject to a tax of 0.1-cent-per-gallon to fund the Leaking Underground Storage Tank Trust Fund.

[1485] Inland Waterways Users Board, Inland Waterways Trust Fund Status Report, prepared for Inland Waterways Users Board Meeting No. 64, Bettendorf, Iowa, October 20, 2010 (revised) available at http//www.waterwayusers.us?IWTF_status 64.pdf. Financial information is based on unaudited Treasury data.

[1486] *Ibid*. The balance includes a $20.3 million "Liability for Allocation" as of September 30, 2010 that is not available for new obligations, leaving a balance of $36.6 million.

The fee system based on lock usage is phased in beginning on October 1, 2012. For calendar year 2016 and each subsequent calendar year, the fee schedule would be adjusted as necessary to maintain an appropriate level of net assets in the Inland Waterways Trust Fund.

Effective date.−The proposal is effective on the date of enactment.

Analysis

The nation's waterway infrastructure is aging and there will be an increasing need to replace it. Many locks are over 50 years old and have outlived their original engineered life.[1487] This will require additional funds. The President's budget proposal seeks to raise these additional funds through the imposition of a user fee in lieu of the present inland waterway tax.

Proponents of the proposal argue that the excise tax does not raise enough revenue to pay for the construction and rehabilitation of the locks and dams on the inland and intracoastal waterways. Some argue that instead of imposing a new fee, the excise tax rate could be increased to provide the necessary funding. However, it has been argued that the excise tax is an inefficient method for raising the necessary funds and that user fees should be imposed on the basis of the costs of the projects. Proponents argue a fee based on the cost to improve a lock that is imposed on the user of such lock would be more equitable than a tax imposed on all users regardless of whether they will use the facilities since the beneficiaries of the construction project would be paying for its cost. It is not clear from the proposal whether the fees will be set according to each project or set based on an aggregate level of spending to be incurred for that fiscal year. If the same rate applies regardless of the facility being used, the arguments that a fee is more efficient and equitable than a tax are not as strong.

Some argue that a fee structure allows for more flexibility than a tax, allowing the fees to be increased when needed to meet construction needs and reduced when that level of spending is no longer needed. Adjusting the tax would require action by Congress. A user fee also could reduce congestion on the waterways as some look for alternate means of transportation to avoid the fee.

Others argue that the insufficient trust fund balance is a result of project cost overruns and seriously delayed construction pace. They note that the highest priority projects are expected to take 20 years or more to complete, meaning that current payors into the trust fund will realize no benefits until far into the future. Opponents of the new fees argue that until the project management issues can be resolved to provide more timely and cost effective benefits, increased funding should not be provided to continue an inefficient system.

An increased fee or tax increase specific to a construction project in that area could negatively affect commerce in that area. In some cases, basing the fee on costs could result in dramatic increases as the costs of certain projects may far exceed others. For example, the average four-barge tow on the Columbia-Snake River System pays about $684 in diesel taxes,

[1487] Inland Waterways Users Board, *22nd Annual Report to the Secretary of the Army and the United States Congress* (May 2008), p. 1.

one way. Under similar lock usage proposal proposed by the Bush Administration, a four-barge tow that transits all eight locks on the Columbia Snake River System would incur a fee of $2,560 each way.[1488] Opponents argue that such increases could cause the diversion of cargo to more polluting methods of transportation.[1489] They argue that barge transportation surpasses truck and rail transportation in terms of safety, fuel efficiency, emissions and congestion impacts.[1490] Thus, the proposal, in the view of its opponents, would penalize the more efficient mode of transportation.

Opponents argue that the fuel tax is more equitable than the lock usage fee as a method of supporting the Inland Waterways Trust Fund. They note that the inland waterways system confers national benefits, however only those that transit through the locks would be subject to the new fees required to pay for the system. On the other hand, general revenues are contributed toward 50 percent of the construction costs, which arguably represents the national benefit and some would argue that the new lock usage fee is to bring user support more in line with the benefits derived from the inland waterway system.

Prior Action

A similar proposal was included in the President's fiscal year 2009, 2010, and 2011 budget proposals.

[1488] Pacific Northwest Waterways Association, Nor'wester, Issue 302, *Administration Releases Details of Proposed Lockage Fee for Inland Waterways* (April 11, 2008) available at: http://www.pna.net/new/Norwester_Articles/Norwester_302.htm.

[1489] Stephen D. Little, *Statement of Stephen D. Little on behalf of Waterways Counsel Inc., Before the Subcommittee on Water Resources and Environment, Committee on Public Works and Transportation, U.S. House of Representatives* (April 30, 2008), p. 3.

[1490] Inland Waterways Users Board, *22nd Annual Report to the Secretary of the Army and the United States Congress* (May 2008), p. 3, *citing* Center for Ports and Waterways, Texas Transportation Institute, *A Modal Comparison of Domestic Freight Transportation Effects on the General Public* (December 2007).

PART XI − OTHER INITIATIVES

A. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents

Present law

The IRS has the authority to credit any Federal tax overpayment against any other Federal tax liability owed by the person who made the overpayment. The balance of the overpayment is generally refunded, unless a claim has been made for payment of certain non-tax debts of that person. Non-Federal tax debts that may be claimed against overpayments of Federal tax liability include past-due support (within the meaning of the Social Security Act), debts owed to Federal agencies, State income tax obligations of taxpayers who reside in the State requesting offset, and unemployment compensation debts.[1491]

The order in which non-tax debts may be satisfied by offset against a Federal tax overpayment is established by statute. The highest priority is accorded to other Federal income tax debts, followed by past-due support (within the meaning of the Social Security Act)[1492] and any other debt owed to any Federal agency.[1493] If more than one unemployment compensation or State income tax debt is owed by the same individual to a State, these debts are satisfied by the overpayment in the order in which the debts accrued, without regard to whether they arise from State income tax or unemployment compensation. The actions of the IRS in reducing the overpayment to satisfy the foregoing debts are not subject to judicial review.[1494] In the event that a payment to a State is determined to have been erroneously made by the IRS in the exercise of its authority to offset for either State income tax or unemployment compensation debt, the State is required to promptly repay upon notice from the IRS.[1495]

Description of Proposal

Offset of Federal refunds to collect State income tax would be permissible regardless of where the delinquent taxpayer resides.

Effective date.–The proposal is effective upon date of enactment.

[1491] Sec. 6402(c) - (f).

[1492] 42 U.S.C. sec 664(c) defines "past-due support" as the amount of a delinquency, determined under a court order, or an order of an administrative process established under State law, for support and maintenance of a child (whether or not a minor), or of a child (whether or not a minor) and the parent with whom the child is living.

[1493] Sec. 6402(f)(2).

[1494] Sec. 6402(g).

[1495] Secs. 6402(e)(7) (with respect to State income tax) and 6402(f)(6) (with respect to unemployment compensation debt).

Analysis

In support of the proposal, the Administration points to the possibility that a delinquent taxpayer could escape Federal offset for delinquent State taxes as long as he or she is a nonresident of the requesting State. The Administration argues that foreclosing this possibility would better leverage the capacity of the Federal tax offset program for the country as a whole. By expanding the offset procedures to all State income tax debts, regardless of the State in which the taxpayer resides, the proposal increases the ability of States to collect finally determined taxes. The proposal has an added benefit, in that the development of additional administrative procedures for the State submitting the application may not be required. In addition, because the IRS would no longer need to determine whether a taxpayer remains a resident of the State requesting offset, some costs of administration may be reduced. Some may question, however, whether leveraging the capacity of the Federal offset program in this manner is appropriate, in that it effectively provides each State with a national collection agent to collect from persons who may otherwise be outside the reach of the State tax authority.

This proposal would provide parity between requests for offset of refunds to assist in collection of State income tax and requests for offset of refunds to satisfy overpaid unemployment benefits. The treatment of residency in considering whether a State debt is eligible for offset against the Federal tax refund arguably should be uniform to ease administration and to avoid unfair results. For example, present law accords State income tax obligations a relatively highly priority, after Federal income tax, child support and other Federal debts, but on the same priority as unemployment compensation. If the same taxpayer owes both State income tax and overpaid unemployment benefits, the priority rules require that offset is applied first to the older of the two debts. Because refund offset to satisfy a State income tax debt is permitted only if the taxpayer is a current resident of the State, a taxpayer who is a former resident of the requesting State would be subject to offset only with regard to the unemployment compensation debt, regardless of the age of the State income tax debt.

Any draft legislation of this provision will need to address concerns that States may favor current residents over former residents in requesting refund offsets. If a State is permitted to distinguish between offsets with respect to residents and non-residents, a State may seek offsets with respect to debts owed by non-residents more readily than it seeks offsets with respect to its current residents, arguably resulting in the disparate treatment of similarly situated individuals. However, enforcing a rule against consideration of residency would be difficult to enforce, and would place the IRS in the position of reviewing the administrative decisions of a State tax authority.

Prior Action

A similar proposal was included in the President's fiscal year 2011 budget proposal.

B. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of Our Economy

Present Law

General rule

Under present law, section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to such information except as provided by specified exceptions.

Returns and information returns

A "return" means any tax or information return, declaration of estimated tax, or claim for refund which, under the Code, is required (or permitted) to be filed on behalf of, or with respect to, any person. It also includes any amendment, supplemental schedule or attachment filed with the tax return, information return, declaration of estimated tax or claim for refund. For example, Form W-2, Wage and Tax Statement, is an information return, and is the return of both the employer who filed it with the IRS and the employee with respect to whom it was filed.

Return information

The Code defines "return information" broadly. It includes a taxpayer's identity (the name of the person with respect to whom a return is filed, his or her mailing address, his or her taxpayer identifying number ("TIN"), social security number ("SSN") or a combination thereof). In addition to taxpayer identity, return information includes any information gathered by the IRS with regard to a taxpayer's liability under the Code, including the following data:

- the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;
- whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing;
- any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense;
- any part of any written determination or any background file document relating to such written determination which is not open to public inspection under section 6110;
- any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to the agreement or any application for an advance pricing agreement; and

- any agreement under section 7121 (relating to closing agreements), and any similar agreement, and any background information related to such agreement or request for such agreement (sec. 6103(b)(2)).

The term "return information" does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. However, return information with the identifiers (name, address, SSN) simply removed is still protected by section 6103.

Exceptions to the general rule of confidentiality for statistical use

Section 6103(j) permits the disclosure of returns and return information for statistical use. The information received under this section can only be redisclosed in a form that cannot identify the taxpayer, unless it is being provided to the taxpayer. Upon written request by the Secretary of Commerce, returns and return information are available to the Bureau of the Census ("Census"). Corporate return information is available to the Bureau of Economic Analysis ("BEA") as provided by regulation for the purpose of structuring censuses, national economic accounts, and related statistical activities.[1496] The Bureau of Labor Statistics ("BLS") is not authorized to receive confidential returns and return information.

Safeguards against and penalties for unauthorized disclosure or inspection of returns and information

Safeguards

Section 6103 requires as a condition for receiving tax information, that recipient agencies establish, to the satisfaction of the IRS, physical, administrative and technical safeguards to the protect the confidentiality of the information received.[1497] Such safeguards include a standardized system of records with respect to requests for disclosure of tax information and the reason for such disclosure, secure storage for the tax information, restrictions which limit access to the tax information to persons whose duties and responsibilities require access, and other safeguards as the IRS deems appropriate. The IRS is to review the safeguards established by such agencies and is permitted to terminate access if the safeguards are found unsatisfactory.

[1496] Treas. Reg. sec. 301.6103(j)(1)-1(c). Such information includes Statistics of Income transcript edit sheets regarding designated categories of corporations and microfilm records regarding corporate returns as needed. Treas. Reg. sec. 301.6103(j)(1)-1(c)(1). The Social Security Administration can redisclose to the Bureau of Economic Analysis a limited amount of corporate return information that it receives from the IRS. Treas. Reg. sec. 301.6103(j)(1)-1(c)(2).

[1497] Sec. 6103(p)(4). See also Internal Revenue Service, Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies: Safeguards for Protecting Federal Tax Returns and Return Information* (2010).

Civil and criminal penalties for unauthorized disclosure or inspection

The Code provides for criminal penalties and civil damages in the event of an unauthorized disclosure. The willful unauthorized disclosure of tax information is a felony punishable by a $5,000 fine, up to five years imprisonment, or both.[1498] Willful unauthorized inspection of tax information is a misdemeanor punishable by a $1,000 fine, up to one-year imprisonment or both.[1499] Federal employees and officers are required to be discharged from employment upon conviction of willful unauthorized disclosure or inspection.

An action for damages against the United States is permitted when any Federal officer or employee knowingly or by reason of negligence inspects or discloses tax information in violation of any provision of section 6103.[1500] A plaintiff is entitled to: (1) actual damages sustained as a result of unauthorized disclosure (including punitive damages for willful or grossly negligent disclosures), or (2) liquidated damages of $1,000 per disclosure, whichever is greater, as well as costs of the action and in certain cases, attorney fees. No liability arises from a good faith but erroneous interpretation of section 6103 or a disclosure made at the request of the taxpayer.

Description of Proposal

Bureau of Economic Analysis

The proposal expands BEA access to confidential return information to cover sole proprietorships with receipts in excess of $250,000 and the return information of all partnerships. BEA contractors would not have access to confidential return information.

Bureau of Labor Statistics

Officers and employees of BLS would have access to business and tax-exempt entity name, trade name, mailing address, and physical location address; taxpayer identification number; principal industry activity (including business description); number of employees and total business-level wages (including wages, tips, and other compensation quarterly from Form 941 and annually from Forms 943 and 944); and sales/revenue for employer businesses only. Unlike BEA, the proposal is not restricted to any particular type of business (i.e. corporate, partnership or sole proprietorship). BLS would not have access to the confidential information of individual employees.

For the purpose of synchronizing BLS and Census business lists, employees of State agencies will receive from BLS the following identity elements for the purpose of, but only to the extent necessary in, analyzing and independently verifying BLS/Census discrepancies as part the BLS synchronization of its business list with Census: business name(s), address(es), principal

[1498] Sec. 7213(a)(1).

[1499] Sec. 7213A(a)(2)(b).

[1500] Sec. 7431.

industry activity (including business description), and taxpayer identification number. Under the proposal, no BLS contractor or State agency contractor has access to confidential return information. BLS is required to monitor compliance by State agencies with the prescribed safeguard protocols.

Effective date.−The proposal is effective on the date of enactment.

Analysis

Background relating to section 6103

Due to concerns regarding the possible misuse of returns and return information, section 6103 was amended in the Tax Reform Act of 1976.

> It has been stated that the IRS probably has more information about more people than any other agency in this country. Consequently, almost every other agency that has a need for information about U.S. citizens, therefore logically seeks it from the IRS. However, in many cases, the Congress has not specifically considered whether the agencies which have access to tax information should have that access. . . .
>
> Questions have been raised and substantial controversy created as to whether the present extent of actual and potential disclosure of return and return information to other Federal and State agencies for nontax purposes breaches a reasonable expectation of privacy on the part of the American citizen with respect to such information. . . . In a more general sense, questions have been raised with respect to whether tax returns and tax information should be used for any purposes other than tax administration. . . .[R]eturns and return information should generally be treated as confidential and not subject to disclosure except in those limited situations delineated in the newly amended section 6103 where the committee decided that disclosure was warranted.[1501]

In reviewing each of the areas in which returns and return information were subject to disclosure, Congress sought to balance a particular office's or agency's need for the information with the citizen's right to privacy and the related impact of the disclosure upon the necessary continuation of voluntary compliance with the country's tax assessment system. Legislation at that time clarified the rules governing disclosure of taxpayer return information, providing that returns and return information are confidential and not subject to disclosure except in those limited circumstances set forth in section 6103 in which Congress determined that disclosure was warranted.

At the time of the revision of section 6103 in 1976, both Census and BEA had access to confidential tax information and maintained that access under the revision. In connection with the 1976 Act, Census did a study of the effect of totally barring it from receiving information

[1501] S. Rep. No. 94-938 p. 317, 1976-3 C.B. 355.

from the IRS. It found that such a prohibition would cause the cost of collecting data to increase significantly, while decreasing the quality of the statistics developed.[1502]

With regard to statistical use, it was stated:

> The committee recognizes the importance to other Federal agencies to be allowed the use of returns and return information in connection with certain of their statistical and research functions. Since there does not appear to be any real likelihood that the use of returns and return information by these agencies would, under the procedures and safeguards provided for in this amendment, result in an abuse of privacy or other rights of the taxpayers whose returns and return information is used, the committee decided that the use of returns and return information should be available for statistical use by certain agencies other than the IRS.[1503]

Synchonization of business lists

The Census Business Register is a database of U.S. business establishments and companies for statistical program use. It covers all domestic businesses (except private households and governments) and organizational units of multi-establishment businesses. The Business Register is constructed using both confidential tax information and non-tax data from Census surveys. Since BEA and BLS are not authorized to access confidential tax information to the same extent as Census, the fact that the Business Register contains confidential tax information prevents Census from completely sharing its Business Register. Thus, because the agencies are unable to synchronize their business lists, they may classify the same businesses differently based on different data, resulting in differences in statistical reporting when categorized by business sector. Sharing the confidential tax information embedded in the Census Business register could improve consistency in classification by industry and region and resolve some reporting anomalies.

In addition to allowing the sharing of confidential tax information among the three principal agencies (Census, BEA, and BLS), the proposal allows disclosure of such information to employees of State agencies for the purpose of synchronizing the BLS and Census business lists. Some may argue that as confidential information is more widely distributed, the opportunities to breach that confidentiality increase. Thus, the information at issue could be distributed amongst all 50 States for verification, with the possibility of multiple locations within a State that would need to be overseen and secured. BLS would be responsible for overseeing State compliance with safeguard protocols. However, some might question whether BLS has adequate resources to perform such oversight for every State and with sufficient frequency.

Beyond the issue of physical security of the confidential information is the general concern for privacy when a taxpayer's confidential information is distributed outside the IRS on

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[1502] S. Doc. 94-266, *Report on Administrative Procedures of the Internal Revenue Service to the Administrative Conference of the United States*, 98th Cong. 2d Sess., p. 884 (October 1975).

[1503] S. Rep. No. 94-938 p. 333.

a nonconsensual basis for a nontax purpose. Some would argue that a taxpayer's privacy becomes significantly diminished the more widely the taxpayer's confidential information is distributed. The more people authorized to have access, the less "private" the information becomes. The proposal, by extending access to BLS and the States, has the potential to significantly broaden the number of persons outside the IRS with access to a taxpayer's confidential information, thereby lessening the privacy of the information. As noted above, the expansion of disclosure to persons or entities increases the risk that the recipients of the information are not themselves subject to oversight and increases chances of an inadvertent unauthorized disclosure. However, even if such persons are appropriately supervised, the expanded authorized disclosure dilutes the confidentiality of the information.

Others note that the information distributed to the States is limited to taxpayer identification number, business name, business address and industry code. Some would argue that as this information is related to businesses, it is not as sensitive. However, others might note that the proposal permits BLS and State agencies to have access to information regarding businesses operating in sole proprietorship form and thus could involve the distribution of information of businesses operated by individuals.

Disclosure of sole proprietorship information to BEA

BEA access to confidential tax information is currently limited to that of corporations. The proposal would give officers and employees of BEA access to the tax information of sole proprietorships with receipts greater than $250,000, and of all partnerships. Some might argue that the proposal represents an infringement on individual taxpayer privacy as it relates to sole proprietorships and to some extent partnerships comprised of individuals. However, some might argue that the infringement is tolerable given the growth of non-corporate businesses and the need for accurate measurements of income and transactions in formation of fiscal policies. Further, by limiting the sole proprietorship data to those proprietorships with receipts greater than $250,000, some might argue that the proposal seeks to diminish the infringement on personal privacy by targeting only those businesses with significant revenues that might have more significance in developing accurate measures of the economy.

Prior Action

No prior action.

C. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General For Tax Administration

Present Law

The Treasury Inspector General for Tax Administration ("TIGTA") is an independent inspector general within the Department of the Treasury whose primary focus and responsibility is to audit, investigate, and evaluate IRS programs and operations. Section 5 of the Inspector General Act of 1978, as amended, requires that each Inspector General submit semiannual reports to Congress summarizing the activities of the Office during the preceding six month period and specifies the minimum content for such reports. Section 7803(d) of the Code provides additional items to be included in one of the semiannual reports prepared by TIGTA (thus making these items subject to an annual reporting requirement). Among the items are evaluations of the implementation of various taxpayer rights protections, and the compliance of the IRS with certain Internal Revenue Service Restructuring and Reform Act of 1998 ("IRS Reform Act") provisions, including:

- The restrictions under section 1204 of the IRS Reform Act on the use of enforcement statistics to evaluate IRS employees;
- The restrictions under section 3707 of the IRS Reform Act on designation of taxpayers (illegal tax protestor designations); and
- Any termination or mitigation under section 1203 of the IRS Reform Act (violations for which IRS employees may be terminated).[1504]

In addition, TIGTA must report on whether the IRS is complying with (1) the requirements of section 6103(e)(8) of the Code to disclose information to an individual filing a joint return on collection activity involving the other individual filing the return, and (2) the restrictions under section 7521 of the Code on directly contacting taxpayers who have indicated that they prefer their representatives be contacted. TIGTA also must report information regarding any administrative or civil actions with respect to violations of the fair debt collection provision of section 6304 of the Code, including a summary of such actions initiated since the date of the last report, and a summary of any judgments or awards granted as a result of such actions.

Description of Proposal

The proposal eliminates the statutory requirement to report on IRS compliance with sections 6103(e)(8) and 7521 of the Code and to report information regarding administrative and civil actions related to fair debt collect provisions under section 6304 of the Code. The proposal makes the remaining annual reporting requirements subject to reporting every two years.

Effective date.−The proposal is effective on the date of enactment.

[1504] See sec. 7803(d)(1).

Analysis

According to TIGTA, IRS management information systems do not separately record or monitor the information needed for TIGTA to properly evaluate compliance with section 6103(e)(8) of the Code. TIGTA has also cited the limitations of such systems in its ability to give an opinion with respect to section 7521 of the Code. In its most recent report, TIGTA noted that it has been 12 consecutive years in which it has been unable to give an opinion with respect to section 7521 of the Code. In both cases, TIGTA asserts that there is sufficient IRS guidance, policy and procedures in place for handling such matters. Thus, with insufficient information to evaluate compliance, one might argue that the reporting requirement is not useful. On the other hand, Congress believed these requirements were significant enough to require the force of law and to require TIGTA to monitor IRS compliance. Thus, some might argue that Congress should require the IRS to maintain the appropriate records to enable TIGTA to complete its statutory obligations. However, in its reports TIGTA has not recommended that the IRS systems be modified to capture the necessary data.

Some might argue that reliance solely upon the IRS to prove that the IRS is providing taxpayers with the information and rights required under these provisions is somewhat flawed and that an independent source, such as the records of the National Taxpayer Advocate, might be a more useful indicator of whether a problem persists. For example, if these items were a serious problem, the National Taxpayer Advocate could include them in the Advocate's annual report that includes the 20 most serious problems facing taxpayers and other information the Advocate deems advisable to include.[1505]

The proposal changes the remaining items subject to annual reports to items for which a report is made every two years. For example, the report on the use of enforcement statistics to evaluate employees, illegal tax protestor designations and violations for which IRS employees may be terminated are annual requirements. Some might argue that knowledge of an annual review acts as a deterrent for the behavior. In addition, some might argue that every two years does not provide Congress with timely information regarding these items and whether there is an increasing trend within the IRS in these negative behaviors. On the other hand, some might argue that the instances of these behaviors are so small so as to not to require monitoring every year. For example TIGTA found that out of approximately 80.6 million records, there were only 196 instances in which a taxpayer had been referred to as a "tax protester" or similar designation. With regard to enforcement statistics, TIGTA found three instances in a review of 1,074 performance evaluations. Some might argue that the instances of such behavior are currently so small that TIGTA resources are best utilized elsewhere.

Prior Action

No prior action.

[1505] See 7803(c)(2)(B)(ii)(III) and (XI) (relating to certain reporting requirements of the National Taxpayer Advocate).

D. Modify Indexing to Prevent Deflationary Adjustments

Present Law

Many parameters of tax law, such as the size of the personal exemption or standard deduction and the width of the income tax brackets, are adjusted annually to prevent the real value of the parameter from changing as a result of inflation. In general deflationary changes in the price level will also cause the nominal value of the relevant tax parameter to fall, such that the real value of the parameter is held unchanged. However, in most cases the nominal value of a parameter is not permitted to fall below its base period level, which could otherwise occur if there were sustained deflation

Description of Proposal

The proposal would provide that no automatic adjustments to tax parameters would occur when there is deflation. Additionally, future inflation adjustments would occur only when the price index exceeded the highest previous level of the price index.

Effective date.−The proposal is effective as of the date of enactment.

Analysis

The general principle behind indexing tax parameters to inflation is to prevent purely inflationary increases (i.e., not real increases) in income from causing a real increase in tax liability. Consider, for example, a taxpayer earning $100,000 in a hypothetical tax system that taxes the first $50,000 of income at a 10 percent rate, and amounts above $50,000 at a 30 percent rate. Such taxpayer would have a tax liability of $20,000 (10 percent of $50,000 plus 30 percent of $50,000). If inflation is running at 10 percent annually, and the taxpayer receives an increase in compensation in the following year only sufficient to compensate for inflation, and thus earns $110,000, the taxpayer's liability would grow to $23,000 (10 percent of $50,000 plus 30 percent of $60,000). The taxpayer's liability is 15 percent greater than the prior year, a growth rate five percentage points greater than if his tax liability increased only at the same rate as inflation and the rate of growth of his nominal income. If the tax system were indexed for inflation, the bracket "break point" at $50,000, where the marginal tax rate increases from 10 percent to 30 percent, would be increased by the 10 percent rate of inflation, to $55,000. The taxpayer's liability would then be 10 percent of $55,000 plus 30 percent of $55,000, or $22,000. The taxpayer's liability would thus increase only at the same nominal rate as inflation if his or her nominal income growth matched only that of inflation. The taxpayer would experience real growth in tax liability only if his or her real income grew−i.e., if income grew faster than the rate of inflation to more than $110,000.

In the fully indexed tax system, the process described above would be reversed during periods of deflation. If price levels declined by 10 percent, then the bracket breakpoint would drop to $45,000, and if the taxpayer's income fell by the amount of deflation to $90,000, liability would drop by the amount of deflation to $18,000. Failure to index the breakpoint for deflation would mean the taxpayer's liability would drop by more than the rate of deflation, to $17,000 (10 percent of $50,000 plus 30 percent of $40,000).

It is not obvious why it would be desirable to have a tax system that is indexed for inflation, but not for deflation, as the case for indexation would seem to be the same in both cases−to keep purely nominal changes in the price level from having real impacts on tax liabilities. The Administration argues that eliminating indexation in the case of deflation would make the tax code a more effective automatic stabilizer than current law. To the extent that this is the case; one might also argue that limiting indexation in the face of inflation would also be a more effective automatic stabilizer than current law. That is, it could be argued that elimination of indexing entirely would improve the automatic stabilizer function of the tax code more than elimination of indexing only for deflation. On balance, modifying the indexing rules to achieve better automatic stabilization in the tax code conflicts with the goal of preventing changes in nominal prices from affecting the real level of one's tax liabilities.

An additional factor to consider is that the indexation features of the tax code operate with a considerable lag. For example, to adjust the size of the rate brackets for 2011 from their 2010 levels, the inflation measure used is the change in the average level of the CPI-U for the 12 month period ending on August 31, 2010, from the average level of the CPI-U for the 12 month period ending on August 31, 2009. Hence, inflation or deflation that occurs in the contemporaneous year, and in the four months preceding that year, has no effect on the tax parameters for that year. The lag in the effect of inflation on tax parameters makes elimination of the indexation features of the tax code a less useful feature for automatic stabilization. In contrast, the progressive rate structure in the current code is considered an effective automatic stabilizer because it operates contemporaneously with economic events--the progressive rates mean that the percentage growth in income tax revenues in a given year will be greater than the percentage growth in income in that year during periods of strong growth, and revenues will fall by a greater percentage than the decline in income during downturns.

Prior Action

No prior action.

PART XII − PROGRAM INTEGRITY INITIATIVES

A. Increase Levy Authority to 100 Percent for Vendor Payments

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[1506] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[1507] and the IRS has provided both notice of intention to levy[1508] and notice of the right to an administrative hearing (referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[1509] at least 30 days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[1510]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[1511]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. In each of these three cases, however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[1512]

[1506] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[1507] *Ibid.*

[1508] Sec. 6331(d).

[1509] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[1510] Sec. 6321.

[1511] Secs. 6331(d)(3), 6861.

[1512] Sec. 6330(f).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[1513] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to Federal contractors (including vendors) that are delinquent on their tax obligations. With respect to Federal payments to vendors of goods or services, the continuous levy may be up to 100 percent of each payment.[1514] The term "goods or services" is not defined in the statute. The levy (either up to 15 percent or up to 100 percent) generally continues in effect until the liability is paid or the IRS releases the levy.

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or IRS releases the levy.

Description of Proposal

The proposal states that it is intended to clarify that the IRS can levy 100 percent of any payment due to a Federal vendor with unpaid tax liabilities, including payments made for the sale or lease of real estate and other types of property not considered "goods or services."

Effective date.–The proposal is effective for payments made after the date of enactment.

Analysis

The 100-percent continuous levy authority was enacted as part of the "American Jobs Creation Act of 2004"[1515] to address perceived abuses of the Federal tax system by some Federal contractors.[1516] In describing the payments to which the 100-percent continuous levy authority applied, the statute specified payments for goods or services sold or leased to the Federal government. Because the term "goods" generally refers only to tangible personal property,[1517]

[1513] Pub. L. No. 105-34.

[1514] Sec. 6331(h)(3).

[1515] Pub. L. No. 108-357.

[1516] H.R. Rep. No. 108-548, pt. 1, p. 360 (2004).

[1517] Uniform Commercial Code sec. 2-103(1)(k) (2004) defines "goods" as "all things that are movable at the time of identification to a contract for sale. The term includes future goods, specially manufactured goods, the unborn young of animals, growing crops, and other identified things attached to realty as described in Section 2-107. The term does not include information, the money in which the price is to be paid, investment securities under Article 8, the subject matter of foreign exchange transactions, or choses in action." This model code has been

the phrase "goods and services" may not encompass payments with respect to real property, including rental payments or royalties. As used elsewhere in the Code, the phrase "goods and services" generally refers to tangible personal property and personal services.[1518] As a result, the extent to which payments with respect to real property or intangible real property were intended to be included within the scope of the 100-percent continuous levy authority has been questioned.

Arguably, the continuous levy authority was intended to reach all Federal payments to government contractors.[1519] Thus, the use of a narrower term, which is inconsistent with its anti-abuse purpose, was inadvertent. On the other hand, FMS reported, in 2005, that it could not implement the 100-percent levy authority with respect to real property, citing the ambiguity in the language:

> The American Jobs Creation Act of 2004, enacted last October, authorized IRS to levy up to 100 percent of certain vendor payments. FMS modified its systems in November 2004, one month after the law was enacted, to implement this authority where 100 percent levy is available. For example, IRS recently levied 100 percent of some Defense Finance and Accounting Service (DFAS) vendor payments and collected $432,000 compared to $100,000 that would have been collected prior to the law's enactment. However, full use of this new statutory authority [to levy up to 100 percent] has been delayed because the provision only permits 100 percent continuous levy for payments for "goods and services" and does not appear to apply to payments made for other kinds of property. FMS stands ready to work with IRS as it attempts to reach a solution to this issue.[1520]

More recently, FMS characterized the problem as a technical drafting error, noting that "[i]n the context of levy, we continue to seek a technical correction to the Internal Revenue Code that would allow IRS to levy up to 100 percent of all Federal vendor payments. This authority was generally granted in 2005 but has not been fully implemented because of a technical

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widely adopted by State legislators, according to the UCC Locator, maintained by the Legal Information Institute at Cornell Law School, www.law.cornell.edu/uniform/ucc.html#a2.

[1518] See, e.g., sec. 274(e)(2) stating that "expenses for goods, services, or facilities" are deductible if treated as compensation to the taxpayer's employee); sec. 170(f)(8)(B)(ii) and (iii) (requiring that the recipient of a charitable contribution provide an acknowledgement that states whether any goods or services were provided by the charity in return for the purported donation).

[1519] The legislative history does not provide much guidance on this point except to use the statutory language. "[A] Federal payment to a vendor of goods or services to the government is subject to continuous levy." H.R. Conf. Rep. No. 108-755, p. 753 (2004).

[1520] Statement of Richard Gregg, Commissioner, U.S. Department of the Treasury, Financial Management Service, before the United States Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, June 16, 2005.

deficiency in the statutory language."[1521] In its description of the budget proposal for fiscal year 2011 (which is in substance the same as the proposal for fiscal year 2012), the Office of Management and Budget similarly characterized the problem as "an imperfection" that has the unintended effect of limiting the levy authority.[1522] The Treasury Department has expressed this same sentiment when describing the current budget proposal for FY 2012 by noting that "a technical correction is needed to ensure that all federal vendor payments are covered."[1523]

The provision eliminates any ambiguity in the statutory language such that the IRS (through FMS) would be permitted to levy up to 100 percent of all Federal vendor payments.

Prior Action

A similar proposal was included in the President's fiscal year 2010 and 2011 budget proposals.

[1521] Statement of Kenneth R. Papaj, Commissioner, U.S. Department of the Treasury, Financial Management Service, before the United States Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, November 14, 2007.

[1522] Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011: Terminations, Reductions, and Savings*, p. 111, available at http://www.gpoaccess.gov/usbudget/fy11/pdf/trs.pdf.

[1523] U.S. Department of Treasury, FY 2012 Budget in Brief, p. 51 (2011), available at http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/FY2012_FMS_508.pdf.

B. Increase Levy Authority for Payments to Medicare Providers with Delinquent Tax Debt

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[1524] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[1525] and the IRS has provided both notice of intention to levy[1526] and notice of the right to an administrative hearing (referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[1527] at least 30 days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[1528]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[1529]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. In each of these three cases, however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[1530]

[1524] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[1525] *Ibid.*

[1526] Sec. 6331(d).

[1527] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[1528] Sec. 6321.

[1529] Secs. 6331(d)(3), 6861.

[1530] Sec. 6330(f).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[1531] authorized the establishment of the FPLP, which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to Federal contractors (including vendors) that are delinquent on their tax obligations. With respect to Federal payments to vendors of goods or services, the continuous levy may be up to 100 percent of each payment.[1532] The term "goods or services" is not defined in the statute. The levy (either up to 15 percent or up to 100 percent) generally continues in effect until the liability is paid or the IRS releases the levy.

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the FMS, such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or IRS releases the levy.

Description of Proposal

The proposal allows Treasury to levy up to 100 percent of a payment to a Medicare provider to collect unpaid taxes.

Effective date.–The proposal is effective for payments made after the date of enactment.

Analysis

In 2008, the Government Accountability Office ("GAO") found that over 27 thousand Medicare providers (i.e., about six percent of all such providers) owed more than $2 billion of tax debt, consisting largely of individual income and payroll taxes.[1533] In one case, a home health company received over $15 million in Medicare payments but did not pay $7 million in federal taxes.[1534]

The GAO report notes that there are several reasons why taxpayers with substantial unpaid federal taxes are able to become Medicare providers and receive payments from Medicare. The Centers for Medicare & Medicaid Services ("CMS") had not (as of 2008) developed rules to (1) require contractors to obtain consent for IRS disclosure of federal tax debts and (2) require CMS or its contractors to screen providers for unpaid taxes.

[1531] Pub. L. No. 105-34.

[1532] Sec. 6331(h)(3).

[1533] Government Accountability Office, *Medicare: Thousands of Medicare Providers Abuse the Federal Tax System*, GAO-08-618 (June 13, 2008).

[1534] *Ibid*., p. 4.

In addition, despite the IRS authority under section 6331(h) to continuously levy up to 15 percent of specified federal payments made to delinquent taxpayers, CMS (as of 2008) had not incorporated most of its Medicare payments into the continuous levy program. Thus, for calendar year 2006, the government lost the chance to possibly collect over $140 million in unpaid Federal taxes.[1535] The GAO notes that CMS officials promised to incorporate about 60 percent of all Medicare fee-for-service payments into the levy program by October 2008 and the remaining 40 percent in the next several years.

Following the GAO study, Congress passed a law directing CMS to participate in the FPLP and ensure that all Medicare provider and supplier payments are processed through it, in specified graduated percentages, by the end of fiscal year 2011.[1536] It is not clear whether or to what extent CMS made good on its promise to incorporate more payments into the levy program. However, it is likely that CMS has brought at least some additional amount of payments into the levy program as directed by Congress.

There seems to be arguments on both sides concerning whether Congress should expand the levy authority to up to 100 percent of a payment to a Medicare provider. On the one hand, it would seem desirable for the government to be able to be paid in full before payments are made out to Medicare providers with past-due tax debt. On other hand, it is not clear that this additional IRS authority will result in the collection of a greater amount of delinquent taxes over time. Now that CMS has pledged (and is mandated by law) to incorporate all of its payments into the levy program, perhaps that will be sufficient to collect the amount owed. However, one could also argue that expanding the levy authority will promote providers' compliance in the future. In response, one could assert that perhaps the compliance gain has already been accomplished with the now realistic threat of the 15 percent levy.

Prior Action

No prior action.

[1535] *Ibid*.

[1536] Medicare Improvement for Patients and Providers Act of 2008, Pub. L. No. 110-275, sec. 189.

PART XIII − MODIFIED PAY-AS-YOU-GO (PAYGO) BASELINE

A. Dividends and Capital Gains Tax Rate Reductions

Present Law

See Part I.G.

Description of Proposal

See Part I.G for a full description of the Administration's budget proposal with respect to the taxation of dividends and capital gains.

The rate reductions for dividends and capital gains for taxpayers with AGI of $200,000 or less for single filers or $250,000 or less for married filers (in 2009 dollars, indexed for inflation thereafter) are those that are considered to be part of the Administration's modified baseline.

Analysis

See Part I.G.

B. Expand Expensing for Small Businesses

Present Law

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[1537] For taxable years beginning after 2009 and before 2012, the maximum amount that a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year.[1538] The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000.[1539] For taxable years beginning in 2012, the maximum amount a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation.[1540] Off-the-shelf computer software placed in service in taxable years beginning before 2013 is treated as qualifying property.

For taxable years beginning in 2013 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).[1541] No general business credit under section 38 is allowed with respect to any

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[1537] Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

[1538] The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to $250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See sec. 179(f)(2).

[1539] The temporary $500,000 and $2,000,000 amounts were enacted in the Small Business Jobs Act of 2010, Pub. L. No. 111-240.

[1540] The temporary $125,000 and 500,000 amounts, indexed for inflation, were enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312.

[1541] Special rules apply with respect to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See sec. 179(f)(4).

amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[1542]

Description of Proposal[1543]

The proposal increases permanently the amount a taxpayer may deduct under section 179.[1544] The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2012, is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation.

In addition, off-the-shelf computer software is treated as qualifying property. Further, a taxpayer is permitted to make or revoke an election for a taxable year under section 179 on an amended Federal tax return for that taxable year without the consent of the Commissioner.

Effective date.–The proposal is effective for taxable years beginning after 2012.

Analysis

The proposal lowers the after-tax cost of capital expenditures made by businesses within a certain size range by permitting the immediate depreciation of the full amount of the capital expenditure (i.e., expensing), rather than depreciation of the expenditure over the recovery period. With a lower cost of capital, it is argued that eligible businesses will invest in more equipment and employ more workers, thus serving to stimulate economic growth among eligible businesses taxable in the United States.

Expensing of capital investments is the appropriate treatment if the policy objective is to tax consumption, because expensing effectively eliminates tax on the returns to investment, subject to certain assumptions.[1545] If the objective is to tax income, then depreciation deductions

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[1542] Sec. 179(c)(1). Under Treas. Reg. section 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

[1543] The proposal includes a provision to extend the rules under section 179 in place for taxable years beginning in 2008 and 2009 to taxable years beginning in 2010. This extension was enacted as part of the HIRE Act of 2010, as noted above.

[1544] This permanent increase is with reference to the rules that would, absent the proposal, apply to taxable years beginning after 2012.

[1545] For example, consider an investment of $100 that yields a $10 return in the following year, i.e., a 10-percent pre-tax return. If the tax rate is 50 percent, expensing of the $100 investment yields a $50 reduction in tax liability, meaning the after-tax cost to the taxpayer for the $100 investment is $50. The $10 return in the following year results in a $5 tax, and thus a $5 after-tax return. Thus, the after-tax return on the investment is 10 percent (5 divided by 50), the same as the pre-tax return. To fully effect consumption tax treatment, other modifications would

should coincide with the economic depreciation of the asset to measure economic income accurately. A depreciation system more generous than economic depreciation, but less generous than full expensing, results in an effective tax rate on the income from capital that is less than the statutory tax rate.

In addition to promoting investment, advocates of expensing assert that increased expensing eliminates depreciation recordkeeping requirements with respect to expensed property. Under the proposal, Federal income tax accounting could be simplified by increasing the portion of capital costs that are expensed in one taxable year and concomitantly reducing those that are recovered through depreciation over the recovery period. It could be argued that the simplification benefit of expensing is not fully realized, however, so long as property is partially depreciated, or so long as some but not all of the taxpayer's property that is eligible for cost recovery is expensed; the taxpayer must still keep records for that property that is subject to depreciation over a period of years.

The proposal increases the $200,000 phaseout threshold amount that would apply for taxable years beginning after 2012 to $500,000 (indexed for inflation), which has the effect of generally permitting larger businesses to obtain the tax benefit of expensing. Some may argue that this result is inconsistent with the idea of limiting expensing to small businesses, as under the present-law provision. They might alternatively argue that in an income tax system, expanding the availability of expensing is not appropriate because it results in a less accurate measurement of economic income. On the other hand, it could be argued that there is no rationale for limiting expensing to businesses below a particular size or with capital expenditures below a certain level.

An advantage of making the increase in the expensing amounts permanent is that it reduces uncertainty with respect to the tax treatment of future investment, thus permitting taxpayers to plan capital expenditures with greater focus on the underlying economics of the investments, and less focus on the tax-motivated timing of investment. Removing tax-motivated distortions in the timing of investment may promote more efficient allocation of economic resources. On the other hand, legislative changes to the expensing rules (principally temporary increases in the amount that can be expensed) have been frequent in the past decade, and there is nothing to prevent additional legislative changes to the expensing rules, regardless of whether the current expensing rules are permanent or temporary. Additionally, to the extent that the rationale for the original increase in the amounts that may be expensed was to provide a counter-cyclical short-term economic stimulus, it can be argued that it is important that such provisions in fact be temporary. If there is uncertainty that a provision providing temporary tax relief may not ultimately be temporary, it can be argued that the stimulative effect of the provision is compromised because the taxpayer need not act within the originally specified time frame of the provision to benefit from it.

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need to be made, such as not imposing capital gains taxes with respect to sales of business equity interests and fully integrating the corporate and individual tax systems. Additionally, no business interest expense deductions could be permitted or negative effective tax rates would result. Finally, even with the changes above, any property taxes imposed at the State or local level would cause there to remain a positive effective tax rate on the return to investment.

Prior Action

A similar proposal was included in the President's budget proposals for fiscal years 2007, 2008, 2009, 2010, and 2011.

C. Marginal Individual Income Tax Rate Reductions

Present Law

In general

The Economic Growth and Tax Relief Reconciliation Act of 2001[1546] created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. These provisions of EGTRRA as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are in effect through 2012.

Tax rate schedules

To determine regular tax liability, a 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. Separate rate schedules apply based on an individual's filing status. For 2011, the regular individual income tax rate schedules are as follows:

[1546] Pub. L. No. 107-16.

Table 4.–Federal Individual Income Tax Rates for 2011

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,500	10% of the taxable income
Over $8,500 but not over $34,500	$850 plus 15% of the excess over $8,500
Over $34,500 but not over $83,600	$4,750 plus 25% of the excess over $34,500
Over $83,600 but not over $174,400	$17,025 plus 28% of the excess over $83,600
Over $174,400 but not over $379,150	$42,449 plus 33% of the excess over $174,400
Over $379,150	$110,016 plus 35% of the excess over $379,150
Heads of Households	
Not over $12,150	10% of the taxable income
Over $12,150 but not over $46,250	$1,215 plus 15% of the excess over $12,150
Over $46,250 but not over $119,400	$6,330 plus 25% of the excess over $46,250
Over $119,400 but not over $193,350	$24,618 plus 28% of the excess over $119,400
Over $193,350 but not over $379,150	$45,324 plus 33% of the excess over $193,350
Over $379,150	$106,638 plus 35% of the excess over $379,150
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,000	10% of the taxable income
Over $17,000 but not over $69,000	$1,715 plus 15% of the excess over $17,000
Over $69,000 but not over $139,350	$9,598 plus 25% of the excess over $69,000
Over $139,350 but not over $212,300	$27,323 plus 28% of the excess over $139,350
Over $212,300 but not over $379,150	$54,399 plus 33% of the excess over $212,300
Over $379,150	$106,725 plus 35% of the excess over $379,150
Married Individuals Filing Separate Returns	
Not over $8,500	10% of the taxable income
Over $8,500 but not over $34,500	$850 plus 15% of the excess over $8,500
Over $34,500 but not over $83,600	$4,750 plus 25% of the excess over $34,500
Over $83,600 but not over $174,400	$17,025 plus 28% of the excess over $83,600
Over $174,400 but not over $379,150	$42,449 plus 33% of the excess over $174,400
Over $379,150	$110.016 plus 35% of the excess over $379,150

The following table is the staff of the Joint Committee on Taxation estimates of the individual rate structure in 2013 upon the expiration of the EGTRRA sunset as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Table 5.–Federal Individual Income Tax Rates for 2013

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $35,500	15% of the taxable income
Over $35,500 but not over $86,000	$5,325 plus 28% of the excess over $35,500
Over $86,000 but not over $179,400	$19,465 plus 31% of the excess over $86,000
Over $179,400 but not over $390,050	$48,419 plus 36% of the excess over $179,400
Over $390,050	$124,253 plus 39.6% of the excess over $390,050
Heads of Households	
Not over $47,600	15% of the taxable income
Over $47,600 but not over $122,850	$7,140 plus 28% of the excess over $47,600
Over $122,850 but not over $198,900	$28,210 plus 31% of the excess over $122,850
Over $198,900 but not over $390,050	$51,786 plus 36% of the excess over $198,900
Over $390,050	$120,600 plus 39.6% of the excess over $390,050
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $59,300	15% of the taxable income
Over $59,300 but not over $143,350	$8,895 plus 28% of the excess over $59,300
Over $143,350 but not over $218,450	$32,429 plus 31% of the excess over $143,350
Over $218,450 but not over $390,050	$55,710 plus 36% of the excess over $218,450
Over $390,050	$117,486 plus 39.6% of the excess over $390,050
Married Individuals Filing Separate Returns	
Not over $35,500	15% of the taxable income
Over $35,500 but not over $86,000	$5,325 plus 28% of the excess over $35,500
Over $86,000 but not over $179,400	$19,465 plus 31% of the excess over $86,000
Over $179,400 but not over $390,050	$48,419 plus 36% of the excess over $179,400
Over $390,050	$124,253 plus 39.6% of the excess over $390,050

Description of Proposal

The proposal permanently extends the 10-percent, 15-percent, 25-percent and 28-percent individual income tax rates. For taxable years beginning after December 31, 2012, the 33-percent rate bracket is split into a 33-percent and a 36-pecent rate bracket. The 35-percent rate bracket becomes the 39.6 percent rate bracket, as per current law.

The proposal sets the top of the 33-percent tax rate bracket (the bottom of the 36-percent rate bracket) so that single individuals with less than $199,350 of taxable income in 2013 ($200,000 of adjusted gross income ("AGI"), assuming one personal exemption and the basic standard deduction, indexed from 2009) will not be subject to the new 36-percent rate.

For married individuals filing joint returns and surviving spouses, the proposal sets the top of the 33-percent tax rate bracket (the bottom of the 36-percent rate bracket) so that individuals with taxable income below $241,900 in 2013 ($250,000 of AGI, assuming two personal exemptions and the basic standard deduction, indexed from 2009) who are currently subject to the 33-percent rate will not become subject to the new 36-percent rate.

For head of household filers, the starting point of the 36-percent bracket is set at the midpoint of the starting points for single filers and married joint filers, rounded down to the nearest $50, or $220,600.

Table 6.–Federal Individual Income Tax Rates for 2013 Under the President's Proposal

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,750	10% of the taxable income
Over $8,750 but not over $35,500	$875 plus 15% of the excess over $8,750
Over $35,500 but not over $86,000	$4,888 plus 25% of the excess over $35,500
Over $86,000 but not over $179,400	$17,512 plus 28% of the excess over $86,000
Over $179,400 but not over $199,350	$ 43,664 plus 33% of the excess over $179,400
Over $199,350 but not over $390,050	$50,248 plus 36% of the excess over $199,350
Over $390,050	$118,900 plus 39.6% of the excess over $390,050
Heads of Households	
Not over $12,500	10% of the taxable income
Over $12,500 but not over $47,600	$1,250 plus 15% of the excess over $12,500
Over $47,600 but not over $122,850	$6,515 plus 25% of the excess over $47,600
Over $122,850 but not over $198,900	$25,328 plus 28% of the excess over $122,850
Over $198,900 but not over $220,600	$46,622 plus 33% of the excess over $198,900
Over $220,600 but not over $390,050	$53,782 plus 36% of the excess over $220,600
Over $390,050	$114,784 plus 39.6% of the excess over $390,050
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,500	10% of the taxable income
Over $17,500 but not over $71,000	$1,750 plus 15% of the excess over $17,500
Over $71,000 but not over $143,350	$9,775 plus 25% of the excess over $71,000
Over $143,350 but not over $218,450	$27,862 plus 28% of the excess over $143,350
Over $218,450 but not over $241,900	$48,890 plus 33% of the excess over $218,450
Over $241,900 but not over $390,050	$56,629 plus 36% of the excess over $241,900
Over $390,050	$109,963 plus 39.6% of the excess over $390,050
Married Individuals Filing Separate Returns	
Not over $8,750	10% of the taxable income
Over $8,750 but not over $35,500	$875 plus 15% of the excess over $8,750
Over $35,500 but not over $86,000	$4,888 plus 25% of the excess over $179,400
Over $86,000 but not over $179,400	$17,512 plus 28% of the excess over $179,400
Over $179,400 but not over $199,350	$43,664 plus 33% of the excess over $199,350
Over $199,350 but not over $390,050	$50,248 plus 36% of the excess over $199,350
Over $390,050	$118,900 plus 39.6% of the excess over $390,050

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

The proposal provides tax relief to a large percentage of taxpayers, which will provide incentives for these taxpayers to work, to save, and to invest, which, in and of itself, will have a positive effect on the long-term health of the economy. The proposal also results in increased marginal tax rates on upper income taxpayers (as is provided for by the present-law sunset of EGTRRA as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010), which will correspondingly reduce incentives for these taxpayers to work, to save, and to invest. Opponents of this latter aspect of the proposal often note that many small businesses, and a large fraction of small business income, will be adversely impacted by an increase in the top two tax rates.

Some argue that an increase in the top two tax rates may lead to a greater disincentive to take entrepreneurial risks as the government will take a larger share of any marginal gains from successful ventures. On the other hand, proponents of the proposal observe that, despite these negative consequences, it is appropriate to allow the rates to rise for relatively few upper income taxpayers on account of pressing needs for Federal revenues, deficit reduction and distributional concerns.

Some opponents of any extension of the EGTRRA (as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010) rates argue that the projections for prolonged Federal deficits should be dealt with more aggressively even if it requires allowing more of the EGTRRA (as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010) tax relief to expire. They argue that the long-term economic effects of the increased Federal debt needed to support projected spending and tax relief will adversely affect the United States' long-term economic prospects. Further, they argue that the tax cuts will reduce the ability of the Federal government to pay down the public debt, fund priorities such as education and defense, and secure the future obligations of Social Security and Medicare.

Prior Action

Proposals to permanently extend the 10-percent, 15-percent, 25-percent, and 28-percent individual income tax rates were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010 and 2011 budget proposals.

D. Reinstate the Overall Limitation on Itemized Deductions and the Personal Exemption Phase-out

Present Law

Overall limitation on itemized deductions ("Pease" limitation)

Unless an individual elects to claim the standard deduction for a taxable year, the taxpayer is allowed to deduct his or her itemized deductions. Itemized deductions generally are those deductions which are not allowed in computing adjusted gross income ("AGI"). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to EGTRRA, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers. In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer's AGI exceeded a threshold amount which was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent.

Pursuant to the general EGTRRA sunset as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the limitation becomes fully effective again in 2013. Adjusting for inflation, the Joint Committee Staff estimates the AGI threshold would be $172,250 for 2013.

Personal exemption phase-out for certain taxpayers ("PEP")

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2011, the amount deductible for each personal exemption is $3,700. This amount is indexed annually for inflation.

Prior to EGTRRA, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. (The phase-out rate was two percent for each $1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed was phased-out over a $122,500 range (which was not indexed for inflation), beginning at the applicable threshold.

Pursuant to the general EGTRRA sunset as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the personal exemption phase-out limitation becomes fully effective again in 2013. According to Joint Committee Staff estimates the PEP thresholds for 2013 would be: (1) 172,250 for unmarried individuals; (2) 258,350 for married couples filing joint returns; and (3) $215,300 for heads of households.

Description of Proposal

Overall limitation on itemized deductions ("Pease" limitation)

The proposal would modify the overall limitation on itemized deductions. Specifically, the overall limitation on itemized deductions would apply with a new AGI threshold beginning in 2013. For 2013, the AGI threshold would be determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This 2009 dollar amount is $200,000 ($250,000 for joint returns). Future years would be adjusted for inflation. Adjusting for inflation, the Joint Committee Staff estimates the dollar amounts of the AGI threshold for 2013 would be $209,150 ($261,450 for joint returns).

Personal exemption phase-out for certain taxpayers ("PEP")

The proposal would modify the personal exemption phase-out. Specifically, the personal exemption phase-out would apply with a new AGI threshold beginning in 2013. For 2013 the AGI threshold would be determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This dollar amount is: (1) $200,000 for unmarried individuals; (2) $250,000 for joint returns; and (3) $125,000 for married couples filing separately. Future years would be adjusted for inflation. Adjusting for inflation, the Joint Committee Staff estimates the AGI thresholds for 2013 would be (1) $209,150 for unmarried individuals; (2) $261,450 for joint returns; and (3) $130,725 for married couples filing separately

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

Overall limitation on itemized deductions ("Pease" limitation)

The general limitation on itemized deductions increases the effective marginal tax rate for affected taxpayers. This limitation reduces (subject to the 80 percent limitation) the amount of certain itemized deductions that may be claimed by an amount equal to 3 percent of each dollar of income in excess of the threshold. Thus, if a taxpayer who is above the threshold earns an additional $1.00 of income, the taxpayer's taxable income increases by $1.03 because the taxpayer's income goes up by $1.00 and the itemized deductions are reduced by 3 cents. For a taxpayer in the 36 percent tax bracket, the increase in tax liability resulting from the $1.00 increase in income will be $0.37 (the $1.03 in additional taxable income multiplied by 36 percent). Generally, the effective marginal tax rate for taxpayers subject to the limitation on itemized deductions is 3 percent higher than the statutory tax rate. That is, the taxpayer's effective marginal tax rate equals 103 percent of the statutory marginal tax rate. However, once the taxpayer's itemized deductions are reduced by 80 percent, the taxpayer's effective marginal tax rate again equals his or her statutory marginal tax rate.

Some argue that the limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions. While there may be a psychological effect, generally there is little or no difference in the tax motivated economic incentive to give to charity for a taxpayer subject to the limitation compared to a taxpayer not subject to the limitation. This is because while the limitation operates effectively to increase the marginal tax rate on the income of

affected taxpayers, the value of the tax benefit of deductibility of the charitable deduction is determined by the statutory tax rate. For taxpayers beyond the threshold, a specified dollar amount of itemized deductions are denied. The specified dollar amount is determined by the taxpayer's income, not by the amount of itemized deductions the taxpayer claims. Hence, the value of an additional dollar contributed to charity increases by exactly one dollar times the total amount of itemized deductions that the taxpayer may claim. Because the statutory rates apply to taxable income (income after claiming permitted itemized deductions), the value of the additional contribution to charity is determined by the statutory tax rate. Economists would say that the "tax price" of giving is not altered by the limitation.[1547]

Proponents of the reinstatement of the Pease limitation (as provided by the sunset provisions of EGTRRA) argue that those who are relatively well-off should be restricted in their ability to benefit from itemized deductions, and that raising more revenue from the relatively well-off is appropriate given the magnitude and growing size of the Federal deficit.

Opponents of the reinstatement of the Pease limitation argue that the overall limitation on itemized deductions is an unnecessarily complex mechanism for imposing taxes and that the "hidden" way in which the limitation raises marginal tax rates undermines respect for the tax laws. The overall limitation on itemized deductions is reflected in a 12-line worksheet. Moreover, the first line of that worksheet requires the adding up of seven line items from Schedule A of the Form 1040, and the second line requires the adding up of five line items of Schedule A of the Form 1040. The legislative history for EGTRRA states that reducing the application of the overall limitation on itemized deductions would significantly reduce complexity for affected taxpayers.

Personal exemption phase-out for certain taxpayers ("PEP")

The personal exemption phase-out would increase effective marginal tax rates for affected taxpayers. The personal exemption phase-out would operate by reducing the amount of each personal exemption that the taxpayer could claim by two percent for each $2,500 (or portion thereof) by which the taxpayer's income exceeded the designated threshold for his or her filing status. Thus, for a taxpayer who was subject to the personal exemption phase-out, earning an additional $2,500 would reduce the amount of each personal exemption he or she could claim

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[1547] This can be seen mathematically as follows. Let Y be the taxpayer's income and X be the threshold above which the limitation on itemized deductions applies. Let D be itemized deductions and t the taxpayer's marginal tax rate. Then the taxpayer's total tax liability, T, is:

$$T = [Y - \{D - (.03)(Y - X)\}]t$$

or

$$T = Y[1 + (.03)]t - Dt - (.03)tX.$$

What this implies is that as the taxpayer's income, Y, increases by $1.00, his or her tax liability increases by $(1.03)t$, as noted in the text. However, if the taxpayer increases his or her itemized deductions, D, by $1.00, his or her reduction in tax liability is t dollars. In other words, the statutory tax rate determines the value of the deduction. This algebra assumes the taxpayer is not subject to the 80-percent limitation.

by two percent, or by $74 in 2011 (0.02 times the $3,700 personal exemption). The taxpayer's additional taxable income would be equal to the $2,500 plus the $74 in denied exemption for each personal exemption. For a taxpayer in the 36 percent statutory marginal tax rate bracket, the effective marginal tax rate on the additional $2,500 of income equals the statutory 36 percent plus an additional 1.07 percent ($74 times the statutory rate of 0.36, divided by the $2,500 in incremental income) for each personal exemption. Thus, if this taxpayer claims four personal exemptions, his or her effective marginal tax rate is 40.3 percent (the statutory 36 percent rate plus four times 1.07 percent). More generally, for 2011 a taxpayer's effective marginal tax rate equals the taxpayer's statutory marginal rate multiplied by one plus the product of 2.96 percentage points (the $74 in denied personal exemption divided by the incremental $2,500 in income) multiplied by the number of personal exemptions claimed. Thus, a taxpayer in the 36-percent rate bracket claiming four personal exemptions would have an effective marginal tax rate approximately 111.8 percent of the statutory marginal tax rate (or 40.3 percent).

Proponents of the reinstatement of the phase-out of the personal exemption (as provided by the sunset provisions of EGTRRA) argue that those who are relatively well-off should be restricted in their ability to benefit from personal exemptions, and that raising more revenue from the relatively well-off is appropriate given the magnitude and growth of the Federal deficit.

Opponents of the reinstatement argue that the high cost of raising children should properly be reflected at all levels of the income distribution, on the grounds that those who are relatively well-off but have no children should face a higher tax burden than those who are relatively well-off but with children, in the same manner that a couple earning $50,000 without children is required to pay more tax than a couple earning $50,000 with children. Opponents further argue that the personal exemption phase-out imposes excessively high effective marginal tax rates on families with children, is an unnecessarily complex mechanism for imposing income taxes, and that the "hidden" way in which the phase-out raises taxes undermines respect for tax laws.

Prior Action

Proposals to repeal the EGTRRA sunset with regard to the personal exemption phase-out and the limitation on itemized deductions were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010 and 2011 budget proposals.

E. Increase of Refundable Portion of the Child Credit

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 through 2012 and $500 thereafter.[1548] A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.[1549]

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 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 adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.[1550]

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2013, is allowed against the alternative minimum tax ("AMT"). To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit[1551] (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula).[1552] Prior to the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the threshold dollar amount was $12,550 (for 2009), and was indexed for inflation. Under the ARRA, the threshold amount (beginning in 2009 and 2010) was $3,000 (the $3,000 amount is not indexed). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set the threshold at $3,000 for both 2011 and 2012 (the $3,000 amount is not indexed). After 2012, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

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 tax credit ("EITC"). After 2012, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

[1548] Sec. 24(a).

[1549] Sec. 24(c).

[1550] Sec. 24(b).

[1551] The refundable credit may not exceed the maximum credit per child of $1,000 through 2012 and $500 thereafter.

[1552] Sec. 24(d).

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 EITC, 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 EITC, 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 shall 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 permanently extends the $1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT. The provision also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT. The proposal permanently extends the earned income formula for determining the refundable child credit, with the earned income threshold of $3,000 (not indexed for inflation). Finally, the proposal permanently extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

This provision doubles the child tax credit (from $500 to $1,000) to provide additional tax relief to families to help offset the costs of raising a child. Proponents embrace the original arguments made for the EGTRRA provisions as support for permanently extending the provisions. Their principal argument is that a tax credit for families with children recognizes the expense of raising children and the importance of helping families raise children. Further, they argue that the refundable child credit should remain widely available to families regardless of the number of children (rather than only families with three or more children), and thus it is important to extend the earned income formula for determining the refundable credit, and to lower the threshold to $3,000 in order to increase the size of the refundable credit for the lowest income workers.

Proponents argue that this expansion of the refundable child tax credit helps offset other Federal tax liabilities to reduce the overall tax burden on working families. Opponents question whether the proliferation of refundable credits unnecessarily contributes to the complexity of the

tax system. Others have also expressed concern about compliance issues with respect to refundable credits. The EITC has special rules related to taxpayers who have improperly claimed the credit in prior years, and consideration could be given to similar rules for the refundable child credit.

Most observers recognize that dependent children affect a taxpayer's ability to pay tax, and believe that fact should be reflected in a taxpayer's tax liability. However, some opponents raise concerns over the cost of the extension. They also note that the dependent exemption, which provides tax relief to many of the same families with dependents as receive the child tax credit, is already part of the Code. In general, opponents argue that the EGTRRA sunset provisions, including the child credit provisions, should be addressed in the context of an overall reform of the tax Code that simultaneously addresses long-term revenue requirements.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010 and 2011 budget proposals.

F. Marriage Penalty Relief and Earned Income Tax Credit Simplification

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately continued to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately are the same. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the EGTRRA rule through 2012.

Fifteen percent rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the EGTRRA rule through 2012.

Earned income tax credit

The earned income tax credit ("EITC") is a refundable tax credit available to certain lower-income individuals. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, and the number of qualifying children.

Description of Proposal

Basic standard deduction

The proposal permanently increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.

15 percent rate bracket

The proposal permanently increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return.

Earned income tax credit

The proposal permanently extends certain EITC provisions adopted by EGTRRA and extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

These include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) a simplified tie-breaking rule; (4) additional math error authority for the Internal Revenue Service; (5) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; and (6) a $5,000 income in the beginning and ending points of the credit phase-out for married taxpayers.[1553]

Effective date.−The proposal applies to taxable years beginning after December 31, 2012.

Analysis

Basic standard deduction and 15-percent rate bracket

Proponents of the extension of these provisions are concerned about the inequity that arises when two working single individuals marry and experience a tax increase solely by reason of their marriage (a "marriage penalty"). Proponents argue that the expansion of the standard deduction and the 15-percent rate bracket for married couples filing joint returns would eliminate the effects of the marriage tax penalty for most taxpayers, and alleviate the effects for others.

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before

[1553] The amount is indexed for inflation annually.

marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $9,350 of his earnings would be tax-free.[1554] However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.[1555] Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. The preponderance of economic evidence shows that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[1556] In addition to fairness arguments, proponents argue for continued marriage penalty relief on economic efficiency grounds.

Any attempt to address the marriage tax penalty involves the balancing of several competing principles, including equal tax treatment of married couples with equal incomes, the determination of equitable relative tax burdens of single individuals and married couples with equal incomes, the degree of progressivity of the tax system, and the goal of simplicity in compliance and administration. It is not possible to have a tax system that has a progressive rate structure, taxes married couples with equal incomes equally, and is neutral with respect to marriage. Opponents of the extension argue that it goes too far in creating marriage bonuses while attempting to alleviate marriage penalties, and imposes too high a relative tax burden on single individuals.

Earned income tax credit

Large marriage penalties exist in the EITC, because the parameters of the credit are based on earned income and numbers of qualifying children and not on marital status (other than the one provision that delays the phase-out of the credit for married taxpayers). Proponents argue

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[1554] As a single taxpayer, the man could claim the standard deduction of $5,800 and one personal exemption of $3,700 for 2011, effectively exempting the first $9,500 of his earnings. This example ignores payroll taxes.

[1555] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 28 percent to 15 percent.

[1556] For a general discussion of legislative history and economic issues with respect to marriage penalty issues see Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax* (JCX-8-01), March 7, 2001. See Congressional Budget Office, *For Better or for Worse: Marriage and the Federal Income Tax*, June 1997, pp. 10-12, for a review of economic literature regarding labor supply issues with respect to the marriage penalty.

that extending the EGTRRA provisions are necessary for two reasons. First, they argue that the reduction in the marriage penalty for EITC filers is particularly important for this low-income population, because the loss or reduction in the credit that marriage could cause might discourage credit recipients from marrying. Second, they believe the simplification provisions have been effective and are worth maintaining. Others respond that simplification proposals should be addressed as part of a more comprehensive reform of the credit to reduce or eliminate high error rates by tax filers.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010 and 2011 budget proposals.

G. Education Incentives

Present Law

Income and wage exclusion for awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under section 117 are also excludable from wages for payroll tax purposes.[1557]

The exclusion for qualified scholarships and qualified tuition reductions 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 scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program").

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2010, as modified by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("EGTRRA"), the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2012.

[1557] Sec. 3121(a)(20).

Income and wage exclusion for employer-provided educational assistance

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.[1558] This exclusion applies to both graduate and undergraduate courses.[1559] 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. 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 individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

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, or (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 (e.g., it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.[1560] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to

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[1558] Secs. 127, 3121(a)(18).

[1559] The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2012 (under EGTRRA's sunset provision).

[1560] Sec. 132(d).

education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended 10 times.[1561] EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2012. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.[1562]

Deduction for student loan interest

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.[1563] 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.

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 an eligible educational institution on at least a half-time basis. Eligible educational institutions are (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, 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. Additionally, to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

The maximum allowable deduction per year is $2,500. For 2011, the deduction is phased out ratably for single taxpayers with AGI between $60,000 and $75,000 and between $120,000 and $150,000 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.

[1561] The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

[1562] Treas. Reg. sec. 1.162-5.

[1563] Sec. 221.

Effective for taxable years beginning after December 31, 2012, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are: (1) increases that were made in the AGI phaseout ranges for the deduction and (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required. With the expiration of EGTRRA, the phaseout ranges will revert to a base level of $40,000 to $55,000 ($60,000 to $75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

Coverdell education savings accounts

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.[1564] 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.[1565] 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.[1566]

Tax-free (including 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 higher education expenses" and "qualified elementary and secondary education expenses."

[1564] Sec. 530.

[1565] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

[1566] 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 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.[1567] 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.[1568]

The term "qualified elementary and secondary education 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 education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee's gross income under section 127.

Effective for taxable years beginning after December 31, 2012, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are: (1) the increase in the contribution limit to $2,000 from $500; (2) the increase in the phaseout range for married taxpayers filing jointly to $190,000-$220,000 from $150,000-$160,000; (3) the expansion of qualified expenses to include elementary and secondary education expenses; (4) special age rules for special needs beneficiaries; (5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution; (6) certain rules regarding when

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[1567] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

[1568] Sec. 530(b)(2)(B).

contributions are deemed made and extending the time during which excess contributions may be returned without additional tax; (7) certain rules regarding coordination with the Hope and Lifetime Learning credits; and (8) certain rules regarding coordination with qualified tuition programs.

Amount of governmental bonds that may be issued by governments qualifying for the "small governmental unit" arbitrage rebate exception

To prevent State and local governments from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.[1569] The Code also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issuers of governmental bonds issued for local governmental activities are not subject to the rebate requirement.[1570] To qualify for this exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[1571] Prior to EGTRRA, the $5 million limit was increased to $10 million if at least $5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from $5 million to $10 million.[1572] Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset (as modified by the 2010 Act).

Issuance of tax-exempt private activity bonds for public school facilities

Interest on bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue act. These bonds are

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[1569] The exclusion from gross income for interest on State and local bonds does not apply to any arbitrage bond (sec. 103(a), (b)(2)). A bond is an arbitrage bond if it is part of an issue that violates the restrictions against investing in higher-yielding investments under section 148(a) or that fails to satisfy the requirement to rebate arbitrage earnings under section 148(f).

[1570] Ninety-five percent or more of the net proceeds of a governmental bond issue are to be used for local governmental activities of the issuer. Sec. 148(f)(4)(D).

[1571] Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. sec. 1.148-8(c)(1).

[1572] Sec. 148(f)(4)(D)(vii).

called "private activity bonds."[1573] The term "private person" includes the Federal government and all other individuals and entities other than State or local governments.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency.[1574] The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes, or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-State private activity bond volume limit equal to $10 per resident ($5 million, if greater) in lieu of the present-law State private activity bond volume limits. As with the present-law State private activity bond volume limits, States can decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

Description of Proposal

The proposal repeals the EGTRRA sunset as it applies to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts. The proposal also repeals the EGTRRA sunset as it applies to the expansion of the small government unit exception to arbitrage rebate and allowing issuance of tax-exempt private activity bonds for public school facilities. Thus, all of these tax benefits for education continue to be available after 2012.

Effective date.–The proposal is effective on the date of enactment.

[1573] The Code provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of section 141. See secs. 103(b)(1), 141.

[1574] Sec. 142(a)(13), (k).

Analysis

Individual benefits

The present-law education tax benefits for individuals that are scheduled to expire under the EGTRRA sunset provision are intended to provide taxpayers with some financial relief for education expenses previously incurred (the modifications to the deduction for student loan interest), for current education expenses (the income and wage exclusion for awards under the NHSC Scholarship Program and the Armed Forces Scholarship Program and the income and wage exclusion for employer-provided educational assistance), and for future education expenses (the modifications to Coverdell education savings accounts). If these provisions are not extended, some of the tax benefits will be completely eliminated (the income and wage exclusion for awards under the NHSC Scholarship Program and the Armed Forces Scholarship Program and the income and wage exclusion for employer-provided educational assistance), while the others will be substantially narrowed (the modifications to the deduction for student loan interest and to Coverdell education savings accounts).

Some people may observe that permanently extending these provisions may lessen the financial burden of obtaining an education for a number of taxpayers. These people may further argue that there is a distinct government interest in having a well-educated populace in the United States, and, as such, it is important for the government to continue programs that encourage the development of such a populace. Other people may observe that there are already substantial nontax incentives to obtaining additional education (e.g., greater lifetime earning potential and increased job opportunities), and these incentives are sufficient to encourage individuals to obtain an appropriate level of education.

An additional argument that some people may make is that permanently extending these provisions will remove from the Code some of the considerable uncertainty inherent in provisions with a temporary existence, which may or may not be extended at some future date. In this particular case, this uncertainty may make it difficult for taxpayers to make optimal decisions today as to the total amount that they should spend on education since they cannot be certain whether tax benefits that may currently be available to them will be available to them in the future, after they have committed themselves to pursuing additional education. As a result, they may overinvest in education, on the assumption that tax benefits will be extended when, ultimately, they are not, or underinvest in education, on the assumption that tax benefits will not be extended when, ultimately, they are. One possible response to this argument is that Congress is aware of the potential for this type of uncertainty whenever it enacts temporary provisions and deems it acceptable for any of a number of possible reasons. For example, Congress may want to revisit the issue in the future, may have insufficient support for a permanent provision, or may feel that a permanent provision is too costly. A second possible response to the argument above is that permanently extending present law is not the only way to achieve certainty; certainty may also be achieved by letting the temporary provisions expire or by enacting a permanent law today that provides for something other than a mere extension of present law.

Bonds for public school facilities

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. It is argued that the exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which typically require voter approval before issuance. Opponents respond that issuers have sufficient financial sophistication that the exceptions are unwarranted.

Proponents of public-private partnerships to improve educational opportunities argue that the new category of private activity bonds allows public-private partnerships to reap the benefit of the implicit subsidy to capital costs provided through tax-exempt financing. Opponents may respond that expansions of allowable private activity bonds can lead to increased borrowing costs for all private activity bonds.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010, and 2011 budget proposals.

H. Other Incentives for Families and Children (includes extension of the adoption tax credit, employer-provided child care tax credit, and dependent care tax credit)

Present Law

Adoption credit and exclusion from income for employer-provided adoption assistance

Present law for 2011 provides: (1) a maximum adoption credit of $13,360 per eligible child (both special needs and non-special needs adoptions); and (2) a maximum exclusion of $13,360 per eligible child (both special needs and non-special needs adoptions).[1575] For 2011, the credit is refundable. These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a $40,000 range for taxpayers with modified adjusted gross income ("modified AGI") in excess of certain dollar levels. For 2011, the phase-out range is between $185,210 and $225,210. The phaseout threshold is adjusted for inflation annually, but the phaseout range remains a $40,000 range.

For 2012, the maximum adoption credit declines, reflecting the expiration of the $1,000 increase to the adoption credit provided for under Section 10909 of the Patient Protection and Affordable Care Act ("PPCCA"). For 2012, the maximum adoption credit is estimated to be $12,540. The credit is not refundable for 2012 and later years.

For taxable years beginning after December 31, 2012, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to $6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between $75,000 and $115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

Employer-provided child care tax credit

Taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per taxable year.

[1575] EGTRRA increased the maximum credit and exclusion to $10,000 (indexed for inflation after 2002) for both non-special needs and special needs adoptions, increased the phase-out starting point to $150,000 (indexed for inflation after 2002), and allowed the credit against the AMT. Section 10909 of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148: (1) extended the EGTRRA expansion of the adoption credit and exclusion from income for employer-provided adoption assistance for one year (for 2011); (2) increased by $1,000 (to $13,170, indexed for inflation) the maximum adoption credit and exclusion from income for employer-provided adoption assistance for two years (2010 and 2011); and (3) made the credit refundable for two years (2010 and 2011). The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRUIRJCA") extended for one year (2012) the EGTRRA expansion of the adoption credit and the exclusion from income for employer-provided adoption assistance. The changes to the adoption credit and exclusion from employer-provided adoption assistance for 2010 and 2011 (relating to the $1,000 increase in the maximum credit and exclusion and the refundability of the credit) enacted as part of the Patient Protection and Affordable Care Act, were not extended by the TRUIRJCA provision.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility; (2) for the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless: (1) it has open enrollment to the employees of the taxpayer; (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code); and (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is the principal trade or business of the taxpayer. Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code.

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2012.

Dependent care tax credit

The maximum dependent care tax credit is $1,050 (35 percent of up to $3,000 of eligible expenses) if there is one qualifying individual, and $2,100 (35 percent of up to $6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income above ("AGI") $15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over $43,000.

The level of this credit is reduced for taxable years beginning after December 31, 2012, under EGTRRA as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Description of Proposals

Adoption credit and exclusion from income for employer-provided adoption assistance

The proposal permanently extends the increase in the adoption credit and exclusion as provided for in EGTRRA (as modified by TRUIRJCA). A separate Administration proposal extends the modifications to the adoption credit and exclusion made by PPACA for one year, through 2012. These modifications raised the maximum credit or exclusion by $1,000 and made the credit refundable.

Employer-provided child care tax credit

The proposal permanently extends this tax benefit.

Expansion of dependent care tax credit

The proposal permanently extends the dependent care tax credit at current levels. A separate budget proposal expands the dependent care tax credit.

Effective date.−The proposals all apply to taxable years beginning after December 31, 2012.

Analysis

Adoption credit and exclusion from income for employer-provided adoption assistance

The adoption credit and exclusion reduce the after-tax cost of adoption for eligible taxpayers. Proponents of the benefits for adoption have argued that increasing the size of both the adoption credit and exclusion and expanding the number of taxpayers who qualify for the tax benefits have encouraged more adoptions and allowed more families to afford adoption.

Some question whether the Code is the appropriate means to subsidize adoption, for reasons including whether the benefits are most appropriately targeted and whether the IRS has the ability to monitor the claims of taxpayers. They argue that such subsidization should be via direct outlay programs, perhaps administered by the States. However, while States might reasonably administer adoption programs for domestic adoptees, it is an open question whether arranging or subsidizing foreign adoptions is an appropriate State function. Some too might argue that it is not an appropriate Federal function to subsidize foreign adoptions through Federal tax credits.

Some express concern that availability of two separate tax benefits for adoptions raises horizontal equity, complexity and compliance issues. While the credit is broadly available, the exclusion applies only to those whose employers provide adoption assistance programs. Comparable tax benefits could be provided to all if the exclusion were eliminated and the credit

were allowed to be claimed on any employer-provided adoption assistance. This would have the effect of treating employer-provided assistance as ordinary compensation and of treating the payment of adoption expenses as paid by the employee from ordinary compensation. The elimination of the exclusion would also simplify the treatment of adoption expenses under the Code.

Employer-provided child care tax credit and dependent care tax credit

While certain tax benefits for children are not dependent on employment (the child credit and dependent exemption for example), the employer-provided child credit and dependent care tax credit are intended to subsidize child care needs related to employment.

Some question whether the Code should provide any child-related tax benefits, on the grounds that having children is a personal choice of private consumption. Others note that the future health of the economy is dependent on the productivity of the next generation of workers, who will also provide the resources that fund the current working generation's Social Security and Medicare benefits, and thus they argue that supporting families that choose to have children is an appropriate public function. Furthermore, they argue, a tax system premised on ability to pay must make allowances for the number of individuals in a tax filing unit.

A separate argument exists for child-care-related tax benefits that relate to child care expenses necessary for employment. The argument is that these child care expenses are an expense of earning income, and thus should essentially be deductible by analogy to general business tax principles that permit deductions for expenses (such as wages paid) necessary to earn income. Furthermore, many economists would argue that a deduction for these expenses would provide income tax treatment that is comparable to the treatment provided home production of child care–i.e, the value of home production is untaxed since the Code does not impute income to the household that provides child care services. Such households are treated as if they had income imputed to them for the services provided, but coupled with a deduction for such expenses, resulting in no increase in net income. If a worker were provided similar treatment via deductibility of child care expense, his net taxable income would rise only to the extent that his compensation exceeded that of his child care expenses.

The dependent care tax credit generally provides tax benefits less valuable than those that a full deduction for child care expense would provide. The principal reason for this is that expenses eligible for the credit are limited to an amount that is substantially less than day care costs for many taxpayers. Additionally, the credit rate for some taxpayers is less than their marginal tax rate, meaning that the deduction for the expense would provide a greater benefit than does a lower-rate credit. For a taxpayer with modest daycare expenses (if, for example, a parent only needs part-time daycare), his expenses might not be limited by the caps, and if he is a low-income taxpayer, he is likely to have a marginal income tax rate below that of the credit rate. Such taxpayer thus receives a tax benefit from the credit that is more generous than a deduction for expenses would provide at his low marginal tax rate.

Arguments for the employer-provided child care tax credit are less clear, as the benefits are not broadly available. While the credit provides benefits to employees and improves the day-care options for employees whose employers utilized the credit, a tax policy rationale for

subsidizing this form of employee compensation over other forms is not immediately apparent when the dependent care tax credit is available. In the absence of the credit for employer-provided child care, an employer may still choose to provide on-site day care if it provides an advantage in recruiting and retaining valued employees. The existence of the employer subsidy and the dependent care benefit arguably provides double benefits for certain taxpayers.

Finally, while many might support the idea that families with children, specifically those with child care costs related to employment earnings, should face a lower tax burden, many among this group would prefer to see a reform of the tax system that simplifies these benefits along traditional tax policy principles, rather than extending provisions set to expire.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010 and 2011 budget proposals.

I. Make Permanent the 2009 Estate, Gift, and Generation Skipping Transfer Tax Provisions After 2012

Present and Prior Law

In general

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

Exemption equivalent amounts and applicable tax rates

In general

Under present law, a unified credit is available with respect to taxable transfers by gift and at death.[1576] The unified credit offsets tax computed at the lowest estate and gift tax rates.

Before 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single applicable exclusion amount applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continued to be determined using a single graduated rate schedule, but the applicable exclusion amount allowed for estate tax purposes was higher than the applicable exclusion amount allowed for gift tax purposes. In 2009, the highest estate and gift tax rate was 45 percent. The applicable exclusion amount was $3.5 million for estate tax purposes and $1 million for gift tax purposes.

For 2009, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exclusion amount in effect at the time of the transfer. The generation skipping transfer tax exclusion for a given year is equal to the applicable exclusion amount for estate tax purposes.

Law in effect after 2009

Under EGTRRA, the estate and generation skipping transfer taxes were scheduled to be repealed for decedents dying and generation skipping transfers made during 2010. The gift tax rate for 2010 under EGTRRA was 35 percent, with a $1 million exclusion amount.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Extension Act")[1577] reinstated the estate and generation skipping transfer taxes

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[1576] Sec. 2010.

[1577] Pub. L. No. 111-312, signed into law December 17, 2010.

effective for decedents dying and transfers made after December 31, 2009. The estate tax applicable exclusion amount is $5 million and is indexed for inflation for decedents dying in calendar years after 2011, and the maximum estate tax rate is 35 percent. For gifts made in 2010, the applicable exclusion amount for gift tax purposes is $1 million, and the gift tax rate is 35 percent. For gifts made after December 31, 2010, the gift tax is reunified with the estate tax, with an applicable exclusion amount of $5 million (indexed for inflation after 2011) and a top estate and gift tax rate of 35 percent.[1578]

The generation skipping transfer tax exemption for decedents dying or gifts made after December 31, 2009, is equal to the applicable exclusion amount for estate tax purposes (e.g., $5 million for 2010).[1579] Therefore, up to $5 million in generation skipping transfer tax exemption may be allocated to a trust created or funded during 2010, depending upon the amount of such exemption used by the taxpayer before 2010. Although the generation skipping transfer tax is applicable in 2010, the generation skipping transfer tax rate for transfers made during 2010 is zero percent. The generation skipping transfer tax rate for transfers made after 2010 is equal to the highest estate and gift tax rate in effect for such year (35 percent for 2011 and 2012).

Election for decedents who die during 2010

In the case of a decedent who dies during 2010, an executor of such decedent's estate is generally allowed to elect to apply the Internal Revenue Code as if the estate tax and basis step-up rules described in the preceding section had not been enacted. In other words, instead of applying the above-described estate tax rules, the executor may elect to have the law enacted under EGTRRA apply. In general, if such an election is made, the estate would not be subject to estate tax, and the basis of assets acquired from the decedent would be determined under the modified carryover basis rules of section 1022.[1580] This election will have no effect on the continued applicability of the generation skipping transfer tax. In addition, in applying the definition of transferor in section 2652(a)(1), the determination of whether any property is

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[1578] Present law rules regarding the computation of estate and gift taxes were clarified under the 2010 Extension Act. The gift tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the tax rate schedule in effect in the current year had been in effect on the date of the prior-year gifts. For purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under section 2001(c) at the time of the decedent's death are used to compute both (1) the gift tax imposed by chapter 12 with respect to such gifts, and (2) the unified credit allowed against such gifts under section 2505 (including in computing the applicable credit amount under section 2505(a)(1) and the sum of amounts allowed as a credit for all preceding periods under section 2505(a)(2)).

[1579] The $5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules.

[1580] Therefore, an heir who acquires an asset from the estate of a decedent who died in 2010 and whose executor elected application of the 2010 EGTRRA rules has a basis in the asset determined under the modified carryover basis rules of section 1022. Such basis is applicable for the determination of any gain or loss on the sale or disposition of the asset in any future year regardless of the status of the sunset provision described below.

subject to the tax imposed by chapter 11 of the Code is made without regard to an election made under this provision.

The Secretary of the Treasury or his delegate shall determine the time and manner for making the election. The election, once made, is revocable only with the consent of the Secretary or his delegate.

Law in effect after 2012

The estate, gift, and generation skipping transfer tax provisions of EGTRRA, as modified by the Extension Act of 2010, sunset at the end of 2012, such that those provisions do not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted will apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2013 or later years. A single graduated rate schedule with a top rate of 55 percent and a single applicable exclusion amount of $1 million, indexed for inflation, for generation skipping transfer tax purposes, will apply for purposes of determining the tax on cumulative taxable transfers by lifetime gift or bequest.

Basis in property received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property.[1581] Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Property received from a donor of a lifetime gift generally takes a carryover basis.[1582] "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax on the transfer. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

[1581] Sec. 1001.

[1582] Sec. 1015.

"Stepped-up" basis in property received from a decedent

Property passing from a decedent generally takes a "stepped-up" basis.[1583] In other words, the basis of property passing from such a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.[1584]

Basis in property received from a 2010 decedent whose estate elects out of the provisions of the Extension Act of 2010

In the case of a decedent who dies during 2010, if the election is made to apply the Internal Revenue Code as if the provisions of the Extension Act of 2010 had not been enacted, the rules providing for date-of-death fair market value ("stepped-up") basis in property acquired from a decedent are not applicable, and a modified carryover basis regime applies.[1585] Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

[1583] Sec. 1014.

[1584] There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of "income in respect of a decedent." Sec. 1014(c). The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was in the hands of the decedent). Income in respect of a decedent includes rights to income that has been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

[1585] Sec. 1022.

An executor generally may allocate additional basis to assets owned by the decedent at death and acquired by the beneficiaries, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse may be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses generally may be increased by up to $4.3 million. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to $60,000.

State death tax credit; deduction for State death taxes paid

State death tax credit under prior law

Before 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate.[1586] The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which served to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.[1587] Such State taxes generally must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

The Extension Act of 2010 allows a deduction for certain death taxes paid to any State or the District of Columbia for decedents dying after December 31, 2009.

Reinstatement of State death tax credit for decedents dying after December 31, 2012

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA, as modified by the Extension Act of 2010, sunset at the end of 2012, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping

[1586] Sec. 2011.

[1587] Sec. 2058.

transfers made after December 31, 2012. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2012. Instead the death tax credit as in effect for decedents who died prior to 2002 will apply.

Exclusions and deductions

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $13,000 (for 2011) on transfers of present interests in property to each donee during the taxable year.[1588] If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $26,000 for 2011. The dollar amounts are indexed for inflation.

Transfers to a surviving spouse

In general.−A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses.[1589] In addition, transfers of "qualified terminable interest property" also are eligible for the marital deduction. "Qualified terminable interest property" is property: (1) that passes from the decedent; (2) in which the surviving spouse has a "qualifying income interest for life"; and (3) to which an election applies. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life; and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse to be effective during the life of the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens.−A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States.[1590] A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

There is generally an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

[1588] Sec. 2503(b).

[1589] Secs. 2056, 2523.

[1590] Secs. 2056(d)(1), 2523(i)(1).

Conservation easements

An executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $500,000.[1591] The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Before 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance of a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA, as amended by the Extension Act of 2010, sunset at the end of 2012, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012. As a result, the EGTRRA modifications to expand the availability of qualified conservation contributions do not apply for decedents dying after December 31, 2012.

Provisions affecting small and family-owned businesses and farms

Special-use valuation

An executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.[1592] The maximum reduction in value for such real property was $1 million for 2009. Real property generally can qualify for special-use valuation if at least 50

[1591] Sec. 2031(c).

[1592] Sec. 2032A.

percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years immediately preceding the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to $675,000.[1593] A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the deduction, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA, as amended by the Extension Act of 2010, sunset at the end of 2012, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012. As a result, the qualified

[1593] Sec. 2057. The qualified family-owned business deduction and the applicable exclusion amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the applicable exclusion amount is $625,000, for a total of $1.3 million. Because of the coordination between the qualified family-owned business deduction and the unified credit applicable exclusion amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds $1.3 million.

family-owned business deduction will apply to estates of decedents dying after December 31, 2012.

Installment payment of estate tax for closely held businesses

Estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).[1594] An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1.36 million[1595] (for 2011 estates as adjusted annually for inflation) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1.36 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code. Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, indirectly through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

[1594] Sec. 6166.

[1595] Sec. 6601(j); Rev. Proc. 2010-40, I.R.B. 2010-46 (November 15, 2010).

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA, as modified by the Extension Act of 2010, sunset at the end of 2012, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012. As a result, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2012.

Generation-skipping transfer tax rules

In general

A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (as defined above).[1596] Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.[1597] An exemption generally equal to the estate tax exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

The transferor is generally the individual who transfers property in a transaction that is subject to Federal estate or gift tax. A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.[1598] Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or

[1596] Sec. 2601.

[1597] Sec. 2611.

[1598] Sec. 2612(c).

otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.[1599] A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).[1600] If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The generation skipping transfer tax generally does not apply to lifetime gifts of a present interest in property up to the annual exclusion amount,[1601] or for certain transfers for educational or medical expenses. A transferor is entitled to a generation skipping transfer tax exemption, equal to the estate tax exemption amount, which may be allocated to transfers made by the transferor either during the transferor's life or at death.[1602]

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The inclusion ratio with respect to any property indicates the amount of "generation skipping transfer tax exemption" allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer. The inclusion ratio is defined as one minus the applicable fraction. The applicable fraction is a fraction the numerator of which is the generation skipping transfer tax exemption allocated to the trust (or the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip) reduced by Federal or State estate and death taxes actually recovered from the trust (or transferred property) and any charitable deduction allowed for Federal estate and gift tax on the transfer.

In the case of a generation skipping transfer trust, the exemption applies to distributions from, or terminations of interests in, that fraction of the trust that the portion of the exemption that is allocated to the trust bears to the value of trust's assets at its creation. Thus, if a generation skipping transfer trust is created in 2011 with $5 million and $5 million of the transferor's generation skipping transfer exemption is allocated to that trust, the inclusion ratio is zero, and no generation skipping transfer tax is imposed on distributions from, or taxable terminations of interests in, that trust regardless of the number of generations of the trust's beneficiaries that are skipped. Alternatively if none of the transferor's generation skipping

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[1599] Sec. 2612(a).

[1600] Sec. 2612(b).

[1601] For 2011, the annual exclusion amount is $13,000.

[1602] The GST exemption amount for 2009 was $3.5 million. The GST exemption amount was increased to $5 million under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 11-312, signed into law December 17, 2010 (the "2010 Extension Act"). The Act extended the sunset provisions of EGTRRA through December 31, 2012. The GST exemption amount reverts to the pre-EGTRRA amount $1 million for transfers after December 31, 2012.

transfer tax exemption is allocated to the trust, the inclusion ratio is one, and generation skipping transfer tax at the maximum rate is imposed on taxable distributions and taxable terminations.

If an individual makes a direct skip during his or her lifetime, any unused generation skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

Modifications to the generation skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor's grandparent predeceases the transferor, then the transferor can allocate any unused generation skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining

the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining the amount of generation skipping transfer tax exemption needed to produce a zero inclusion ratio, and the relief would be retroactive to the date of the transfer.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

Sunset of EGTRRA modifications to the generation skipping transfer tax rules

The estate, gift, and generation skipping transfer tax provisions of EGTRRA, as modified by the Extension Act of 2010, sunset at the end of 2012, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012. As a result, the EGTRRA modifications to the generation skipping transfer tax rules described above will not apply to generation skipping transfers made after December 31, 2012. Instead, in general, the rules as in effect prior to 2001 will apply.

Portability of unused exemption between spouses

Under a termporary provision eanacted as part of the Extension Act of 2010,[1603] any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.[1604]

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of $5 million

[1603] See sec. 303 of Pub. L. No. 111-312 (December 17, 2010).

[1604] The provision does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

or the unused exclusion of the last such deceased spouse.[1605] A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own $5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. The Secretary of the Treasury shall prescribe regulations as may be appropriate and necessary to carry out the rules described in this paragraph.

Example 1.−Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2.−Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3.−Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount[1606] less her $3 million taxable estate). Under the provision, Husband 2's applicable

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[1605] The last deceased spouse limitation applies even if the last deceased spouse has no unused exclusion or the last deceased spouse's estate does not make a timely election.

[1606] The provision adds new section 2010(c)(4), which generally defines "deceased spousal unused exclusion amount" of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the

exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

The EGTRRA sunset, as extended by the Extension Act of 2010, applies to the amendments made by the Act, including the provision for portability of unused exemption between spouses. Therefore, the portability of unused exemption between spouses does not apply to estates of decedents dying after December 31, 2012.

Description of Proposal

The Administration's baseline generally assumes that the estate, gift, and generation skipping transfer tax laws in effect for 2009 are permanently extended for decedents dying and gifts made or generation skipping transfers made after December 31, 2012. Under 2009 law, the applicable exclusion amount for estate tax purposes generally is $3.5 million, and the applicable exclusion amount for gift tax purposes is $1 million. The highest estate and gift tax rate under the proposal is 45 percent, as under 2009 law.[1607]

As under present law, the generation skipping transfer tax exemption for a given year is equal to the applicable exclusion amount for estate tax purposes, and the generation skipping transfer tax rate for a given year will be determined using the highest estate tax rate in effect for such year.

The proposal makes permanent the repeal of the State death tax credit; as under 2009 law, the proposal allows a deduction for certain death taxes paid to any State or the District of Columbia. In addition, the proposal makes permanent the repeal of the qualified family-owned business deduction. Under the proposal, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions, as amended by the Extension Act of 2010, scheduled to occur at the end of 2012, is repealed. As a result, the proposal makes permanent the above-described EGTRRA modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the generation skipping transfer tax.

Effective date.−The proposal is effective for estates of decedents dying, generation skipping transfers made, and gifts made after December 31, 2012.

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basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the temporary provision.

[1607] As under present law, the tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the tax rate schedule in effect for that year had been in effect on the date of the prior-year gifts. In implementing the reinstatement of the 2009 applicable amount, transition rules may be necessary to address the computation of tax with respect to gifts made in years with a higher applicable amount.

Analysis

Transfer tax planning issues

Stability and consistency in the law

As described above, under EGTRRA and the Extension Act of 2010 the estate tax exemption amount and the estate and gift tax rates changed on an almost annual basis between 2002 and 2010. An estate of a decedent dying in 2010 is allowed an election out of the estate tax, and the maximum tax rate applicable to generation skipping transfer taxes in 2010 is zero. Present law provides for two distinct sets of rules for determining basis of assets received from a decedent in 2010. The credit for succession taxes paid to a State was phased out and replaced with a deduction. In addition, increases in the estate tax exemption amount resulted in a phase-out and effective repeal of the deduction for qualified family-owned business interests under section 2057, but section 2057 again will be operative for 2011 and later years. Certain other modifications to the estate and gift tax laws under EGTRRA are scheduled to expire at the end of 2012.

Commentators have advocated a stable and more predictable estate and gift tax system -- without constantly changing parameters, phase-outs, or sunsets -- arguing that the complexity of present law has made estate planning difficult and costly. The American Bar Association's Task Force on Federal Wealth Transfer Taxes argued that, because of the complexity of current law, "[a] significant number of individuals likely will have estate plans with provisions that are inappropriate."[1608] This could arise, for example, because estate planners fail to plan properly for changes in law, taxpayers are reluctant to incur the transaction costs associated with repeatedly modifying estate plans, or taxpayers choose to delay further planning in the hope that they will not die before the estate tax is permanently repealed or substantially reduced. As another example, the ABA Task Force notes that some taxpayers wish to maintain life insurance only if they will have an estate tax liability, but this is difficult to determine when the estate tax laws are unsettled and changing.[1609]

Differences in estate and gift tax exemption amounts

Under the Extension Act of 2010, estate and gift tax applicable exclusion amounts were reunified at $5 million (indexed for inflation after 2011). The budget proposal decouples the applicable exclusions amount, setting the gift tax exemption amount at $1 million, while the estate tax exemption amount is $3.5 million. Commentators have argued that this decoupling of the estate and gift tax exemption amounts complicates wealth transfer tax planning and raises administrability issues, and that the exemption amounts, therefore, should be reunified.

[1608] American Bar Association, Task Force on Federal Wealth Transfer Taxes, "Report on Reform of Federal Wealth Transfer Taxes" (2004) (hereinafter "ABA Task Force"), p. 3.

[1609] *Ibid.*, pp. 3-5.

For example, some commentators argue that, as a result of the lower gift tax exemption amount, taxpayers are likely to engage in complicated and costly planning to avoid gift tax.[1610] They argue that the lower gift tax exemption (and resulting higher cost of the gift tax) could encourage taxpayers to create complicated long-term trusts at death designed to avoid gift tax on transfers to successive generations. They further argue that the lower gift tax exemption will encourage taxpayers to delay transfers until death, "encouraging family wealth to remain 'locked in' older generations."[1611]

The extent to which such practices have increased in use since the exemption amounts were decoupled in 2004 is uncertain. In addition, the effect of the lower gift tax exemption amount from 2004 through 2010 is partially mitigated by a structural difference between the estate tax and the gift tax that generally benefits taxpayers who make inter vivos gifts: the gift tax is "tax exclusive," whereas the estate tax is "tax inclusive." In other words, under the estate tax, the assets used to pay the tax are included in the estate tax base. Thus, if the estate and gift taxes were fully reunified, the gift tax would be a less costly tax.

Furthermore, the gift tax often is viewed as being necessary to protect the income tax base. In the absence of a gift tax, it may be possible for a taxpayer to transfer an asset with built-in gain or that produces income to a taxpayer who is in a lower tax bracket, where the gain or income would be realized and taxed at a lower rate before the asset is gifted back to the original holder. Therefore, if the gift tax applicable exclusion amount were increased to equal the higher estate tax applicable exclusion amount, the effectiveness of the gift tax as a tool to protect the income tax base may be diminished.

Treatment of State death taxes for Federal estate tax purposes

Prior to 2002, Federal law allowed for a credit against the Federal estate tax for any estate, inheritance, legacy or succession taxes (referred to as "State death taxes") actually paid to any State or the District of Columbia.[1612] The credit was determined under a graduated rate table set forth in section 2011(b), which ties the maximum credit amount to the "adjusted taxable estate," which is the taxable estate reduced by $60,000. Under EGTRRA, the amount of the allowable credit was reduced from 2002 through 2004. For decedents dying after 2004, the credit is replaced with a deduction from the gross estate for certain State death taxes actually paid to any State or the District of Columbia.[1613] The budget proposal reinstates and makes permanent the State death tax deduction.

Before the credit was repealed, many States imposed "soak-up" or "pick-up" taxes, i.e., State taxes designed to impose a tax equal to the maximum amount of the Federal credit allowed to a decedent. Such taxes had the effect of shifting revenue to States from the Federal

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[1610] *Ibid.*, p. 22.

[1611] *Ibid.*, pp. 22-23.

[1612] Sec. 2011.

[1613] Sec. 2058.

government, without changing the overall amount of estate tax liability (Federal and State) of a taxpayer. Under prior law, all of the States imposed a tax at a level at least equal to the amount of the State death tax credit allowed under section 2011.[1614] As of March 3, 2011, however, 28 States imposed no State death taxes.[1615]

Some argue that the State death tax credit should be reinstated rather than retaining the present-law deduction. They argue, for example, that the credit served as a powerful funding mechanism for States; because States are struggling financially in the current economy, the States are in critical need of such funding. Furthermore, because it is politically difficult to enact new taxes in many States, some State legislatures have been unable or unwilling to replace existing soak-up taxes (which in some cases now lie dormant because such laws operate only to the extent Federal law allows a credit for State death taxes) with new estate or inheritance taxes, leaving such States without an annual stream of revenue. Some advocates of reinstating the State death tax credit also argue that the absence of Federal credit increases the disparity in estate taxes imposed by the various States, which can (1) lead to competition between States to attract wealthy residents and (2) result in disparate tax treatment of similarly situated individuals, depending only on an individual's State of residence at the time of death.[1616]

Others argue that the State death tax credit should not be reinstated. Some argue, for example, that estate or other succession taxes, whether Federal or State, are undesirable and that the allowance of a Federal credit for State death taxes is a subsidy to States that encourages the enactment or retention of State-level death taxes. Some might also argue that if the intended policy is to provide a funding mechanism for State governments, it would be more direct and efficient to provide a direct Federal government subsidy instead of making an indirect transfer through the tax system.

Federal estate tax and basis of transferred assets

Present law includes two distinct sets of rules for determining the basis of property acquired from a 2010 decedent's estate. The basis of property acquired from estates generally is the property's fair market value at the time of the decedent's death. As a result of this basis step-up (or step-down if property declined in value while owned by the decedent) when a taxpayer sells inherited property, the taxpayer generally does not recognize gain or loss attributable to appreciation or depreciation in the property that occurred during the decedent's holding period. Present law provides a different rule for property acquired from electing estates of decedents dying in 2010. For this property, there is no Federal estate tax, but heirs generally take a carryover basis. This carryover basis preserves in the hands of an heir taxable gain or loss attributable to increases or decreases in the value of property during the decedent's holding

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[1614] ABA Task Force, p. 8.

[1615] See McGuire Woods LLP, 2011 State Death Tax Chart (Revised March 3, 2011), available at *http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf.*

[1616] See, e.g., Jeffrey A. Cooper, "Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective," 33 *Pepperdine Law Review* 835 (2006).

period. A few significant issues related to basis in assets acquired from estates are described below.

Carryover basis may affect a taxpayer's willingness to sell an appreciated asset. In general, a realization-based tax system creates "lock-in," a behavioral distortion that may be described as the reluctance of an individual to sell property and thereby incur tax on the recognition of accrued appreciation in the property. This lock-in reduces the mobility of capital to potentially higher return investments. Proponents of carryover basis argue that allowing inherited property to receive a basis step-up accentuates lock-in. Because income taxes on accrued appreciation can be avoided entirely if the basis of property that passes at death is stepped up to its fair market value at the time of death, an individual may choose not to sell appreciated property before death. Under this argument, carryover basis would reduce lock-in because holding assets until death would not permit avoidance of income tax liability on pre-death appreciation when assets eventually are sold by heirs. Conversely, opponents of carryover basis argue that it perpetuates lock-in because income tax liability for pre-death gains carries over to the heir. Thus, under carryover basis the decedent's beneficiary also may refrain from selling an asset because of the adverse income tax consequences from sale. Opponents of carryover basis argue that the stepped-up basis rule removes the lock-in effect once each generation.

Under carryover basis, taxpayers will be required to establish a decedent's historical cost basis in inherited assets. Commentators have argued that establishing this historical cost basis may be difficult in many cases.[1617] The difficulty may be acute in part because the decedent is no longer available to remember the history of assets and where records of transactions affecting basis might be located. This problem may be especially troublesome in the case of personal residences for which there may be many transactions that affect basis; personal effects such as jewelry; assets such as classic cars that appreciate in value and to which many improvements may be made; and unique assets such as paintings and stamp collections. It may be possible to use presumptions to ameliorate the difficulty of establishing historical cost basis. For example, a rule that presumed the decedent purchased an asset at its value on the date of its acquisition would in some cases limit the necessary knowledge to the date the decedent acquired the asset. In the absence of statutory presumptions, if an heir is unable to establish a decedent's basis in property, a question is whether the IRS will consider the heir to have a zero basis in the property.

A related issue under a carryover basis regime is the role of the executor of an estate in determining the decedent's basis in the assets over which the executor has control.[1618] When carryover basis rules were adopted in 1976, the executor was required to obtain information

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[1617] Nonna A. Noto, "Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal," CRS Report for Congress RL30875, p. 9 (updated April 20, 2001). The report notes that practitioners raised this concern when a previous attempt to institute carryover basis was enacted (and repealed before taking effect) by the Tax Reform Act of 1976. See also AICPA Tax Division, "Reform of the Estate and Gift Tax System," 91 *Tax Notes* 322 (April 19, 2001).

[1618] AICPA Tax Division, supra note 82, p. 326; Task Force on Federal Wealth Transfer Tax, Report on Reform of Federal Wealth Transfer Taxes 72 (2004); Karen C. Burke and Grayson M.P. McCouch, "Estate Tax Repeal: Through the Looking Glass," 22 *Virginia Tax Review* 187, 220 (2002).

about basis and to provide that information to heirs. No such requirement was included in the carryover basis rules adopted in 2001. If rules required executors to provide basis information to beneficiaries or if executors provided information in the absence of a requirement, a question would be whether beneficiaries would be permitted to rely on the information and whether executors would be subject to penalties for failure to report correct or complete information. Although the 2001 rules do not require an executor to provide basis information to beneficiaries, they do provide that an executor must allocate the permitted basis increases (the $1.3 million and $3 million amounts described previously) among estate assets, and they permit broad discretion in making the allocation (subject to a prohibition on using basis additions to create a built-in loss in any single asset). This broad discretion may create difficulties for executors concerned about fiduciary obligations and may create uncertainty for beneficiaries if an executor fails to make an allocation.

Economic issues

Wealth taxes, saving, and investment

Some may argue that a reduction in the estate tax for years after 2012, as under the proposal, would affect taxpayers' saving and investment behavior. Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their saving. Again, there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.

Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs.[1619] It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.[1620] Others believe the bequest motive is not important in

[1619] A discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod, eds., *Rethinking the Estate Tax*, Washington, D.C: The Brookings Institution, (2001). For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," 15 *Journal of Economic Perspectives* (Winter 2001), pp. 205-218.

[1620] See Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," 89 *Journal of Political Economy* (August 1981). Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," 2 *Journal of Economic Perspectives* (Spring 1988). For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role

national capital formation,[1621] and empirical analysis of the existence of a bequest motive has not led to a consensus.[1622] Theoretically, it is an open question whether estate and gift taxes encourage or discourage saving, and there has been limited empirical analysis of this specific issue.[1623] By raising the after-tax cost of leaving a bequest, a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. For example, some individuals purchase additional life insurance to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Wealth taxes and small business

Regardless of any potential effect on aggregate saving, the scope and design of the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. They note that if a family has a substantial proportion of its wealth invested in one

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for Wealth Transfer Taxes," 45 *National Tax Journal* (June 1992). For attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Kreuger (eds.), *The Political Economy of Tax Reform* Chicago: The University of Chicago Press, 1992; and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," 8 *Journal of Economic Perspectives* (Fall 1994), pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

[1621] Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," 2 *Journal of Economic Perspectives* (Spring 1988). In this article, Modigliani argues that 15 percent is more likely an upper bound.

[1622] See B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," 99 *Journal of Political Economy* (October 1991), pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," 77 *American Economic Review* (June 1987), pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings.... Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities." (p. 308).

[1623] Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, Washington, D.C.: The Brookings Institution, 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. They find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging successful avoidance activity.

More recently, David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," 59 *National Tax Journal* (June 2006), pp. 253-268, examines the size of taxable estates and the structure of the estate tax and its effects on the expected rates of return to saving. While he emphasizes the sensitivity of the analysis to how individuals' expectations about future taxes are modeled he concludes that "taxable estates are ten percent smaller because of the estate tax."

enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained. There is some evidence that many businesses may be constrained in the amount of funds they can borrow. If businesses are constrained, they may reduce the amount of investment in the business and this would be a market inefficiency.[1624] One study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[1625]

Others argue that potential deleterious effects of the estate tax on investment by small or family-owned businesses are limited. The 2009 exemption amount is $3.5 million per decedent ($5 million for 2010, 2011, and 2012 (indexed for inflation)). As a result, small business owners can obtain an effective exemption of up to $7.0 million per married couple (or up to $10 million for decedents dying in 2010, 2011, or 2012), and other legitimate tax planning can further reduce the burden on such enterprises. Also, as described above, Code sections 2031A, 2057,[1626] and 6166 are provided to reduce the impingement on small business cash flow that may result from an estate tax liability. Some analysis questions whether, in practice, small businesses need to liquidate operating assets to meet estate tax liabilities. A recent study of 2001 estate returns shows that many estates that claimed benefits under sections 2032A, 2057, or 6166 held liquid assets nearly sufficient to meet all debts against the estate. The study found only 2.4 percent of estates that reported closely held business assets and agricultural assets elected the deferral of tax under section 6166.[1627] Others have argued that estate tax returns report a small fraction of the

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[1624] Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity* (1988), pp. 141-195.

[1625] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," 102 *Journal of Political Economy* (February 1994), pp. 53-75. Holtz-Eakin, Joulfaian, and Rosen study the effect of receipt of an inheritance on whether an entrepreneur's business survives rather than whether an on-going business that is taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a $150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact on their performance: the $150,000 inheritance ... is associated with a nearly 20-percent increase in an enterprise's receipts" (p.74).

These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received. For example, Francisco Perez-Gonzalez, "Inherited Control and Firm Performance," 96 *American Economic Review* (December 2006), pp. 1559-1589, finds that where the incoming CEO is related to the departing CEO, or to a founder, the firm underperforms in terms of profitability and other financial measures.

[1626] As discussed above, section 2057 no longer applies for estates of decedents dying after 2003, but will apply to estates of decedents dying after 2010.

[1627] Martha Eller Gangi and Brian G. Raub, "Utilization of Special Estate Tax Provisions for Family-Owned Farms and Closely Held Businesses," 26 *SOI Bulletin*, Summer 2006, pp. 128-145. Gangi and Raub calculate a liquidity ratio, the ratio of liquid assets (cash, cash management accounts, State and local bonds, Federal government bonds, publicly traded stock, and insurance on the life of the decedent) to the sum of the net estate tax plus mortgages and liens. They found that in 2001 this ratio exceeded one for estates of less than $2.5 million

value of decedents' estates thereby mitigating any special burden that the estate tax may impose on small business.[1628]

Wealth taxes and labor supply

As people become wealthier, they have an incentive to consume more of everything, including leisure time. Some, therefore, suggest that, by reducing the amount of wealth transferrable to heirs, transfer taxes may reduce labor supply of the parent, although it may increase labor supply of the heir. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would . . . ."[1629] Furthermore, the estate tax could increase work effort of heirs as the benefits of the special-use valuation, and the exclusion for qualified family-owned business interests will be lost and recaptured if the assets fail to remain in a qualified use. While, in theory, increases in wealth should reduce labor supply, empirically economists have found the magnitude of these effects to be small.[1630] In addition, the estate tax also could distort, in either direction, the labor supply of the transferor if it distorts his or her decision to make a bequest.

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claiming benefits of the special deduction for qualified family owned business assets or deferral of tax. Larger such estates had average liquidity ratios of 0.5 or more. Generally all estates claiming special use valuations had an average liquidity ratio of at least one. A liquidity ratio of one implies that the estate has liquid assets sufficient to pay the net estate tax plus pay off all mortgages and liens.

[1628] See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance*, Washington, D.C.: The Brookings Institution (1979). Also, see B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers (ed.), *Tax Policy and the Economy* 1, Cambridge, Mass.: The MIT Press (1987); and Alicia H. Munnell with Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, November/December 1988. These studies pre-date the enactment of chapter 14 of the Code. The purpose of chapter 14 is to improve reporting of asset values in certain transfers. Nevertheless, planning opportunities remain whereby small business owners can reduce the cash required to meet an estate tax obligation, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05, January 27, 2005. The Joint Committee staff discusses the ability to use valuation discounts and lapsing trust powers effectively to shelter business (and other) assets from the estate tax on pages 396-408.

[1629] Andrew Carnegie, "The Advantages of Poverty," in *The Gospel of Wealth and Other Timely Essays,* Edward C. Kirkland (ed.), Cambridge, MA: The Belknap Press of Harvard University Press, 1962, reprint of Carnegie from 1891.

[1630] For a review of this issue, see John Pencavel, "Labor Supply of Men: A Survey," in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. I, New York, NY: North-Holland Publishing Co. 1986. For a direct empirical test of what some refer to as the "Carnegie Conjecture," see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," 108 *Quarterly Journal of Economics* (May 1993), pp. 413-435. Holtz-Eakin, Joulfaian, and Rosen assess the labor force participation of families that receive an inheritance. They find that "the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received. For example, families with one or two earners who received inheritances above $150,000 [in 1982-1985 constant dollars] were about three times more likely to reduce their labor force participation to zero than families with inheritances below $25,000. Moreover, ... high inheritance families experienced lower earnings growth than low inheritance families, which is consistent with the notion that inheritance reduces hours of work" (pp. 432-433). Theory suggests also that those who choose to

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, Federal transfer taxes may help prevent an increase in the concentration of wealth. Overall, there are relatively few analyses of the distribution of wealth holdings in the economic literature.[1631] Conventional economic wisdom holds that the Great Depression of the 1930s and World War II substantially reduced the concentration of wealth in the United States, and that there had been no substantial change at least through the 1980s. Most analysts assign no role to tax policy in the reduction in wealth concentration that occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since World War II.[1632]

The income tax does not tax all sources of income. Some suggest that by serving as a "backstop" for income that escapes income taxation, transfer taxes may help promote overall fairness of the U.S. tax system. Still others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the contribution of transfer taxes to the overall fairness of the U.S. tax system.

Even if transfer taxes are believed to be borne by the owners of the assets subject to tax, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A gift tax is assessed on the transferor of taxable gifts. Assume, for example, a mother makes a gift of $1 million to her son and incurs a gift tax liability of $450,000. From one perspective, the

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remain in the labor force will reduce their hours worked or labor earnings. Holtz-Eakin, Joulfaian, and Rosen find these effects to be small.

[1631] For some exceptions, see Martin H. David and Paul L. Menchik, "Changes in Cohort Wealth Over a Generation," 25 *Demography* (August 1988); Paul L. Menchik and Martin H. David, "The Effect of Income Distribution on Lifetime Savings and Bequests," 73 *American Economic Review* (September 1983); and Edward N. Wolff, "Estimate of Household Wealth Inequality in the U.S., 1962-1983," 33 *The Review of Income and Wealth* (September 1987).

[1632] See Michael K. Taussig, "Les inegalites de patrimoine aux Etats-Unis," in Kessler, Masson, Strauss-Khan (eds.) *Accumulation et Repartition des Patrimoines*. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolff, in "Estimate of Household Wealth Inequality in the U.S., 1962-1983," does not attribute any movements in wealth distribution directly to tax policy, but rather to the changes in the relative values of housing and corporate stock.

Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior," in William G. Gale, James R. Hines Jr., and Joel Slemrod (eds.), *Rethinking Estate and Gift Taxation*, Washington, D.C.: The Brookings Institution, 2001, find mixed evidence. Using aggregate time series data, Kopczuk and Slemrod find a negative correlation between the share of wealth held by top wealth holders and the estate tax rates. That finding would imply that the estate tax may mitigate the concentration of wealth among top wealth holders. Wojciech Kopczuk and Emmanuel Saez, "Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns," 57 *National Tax Journal* (September 2004), pp. 445-487, report a similar result. However, when Kopczuk and Slemrod use pooled cross section analysis to make use of individual estate tax return data, they find at best a weak relationship between estate tax rates and wealth holdings.

gift tax could be said to have reduced the mother's current economic well-being by $450,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $2 million, so that the gift tax has reduced the son's economic well-being by $1 million. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and recipient generations may not be important to assessing the fairness of transfer taxes if both the donor and recipient have approximately the same income.[1633]

Federal estate taxation and charitable bequests

The two unlimited exclusions under the Federal estate tax are for bequests to a surviving spouse and for bequests to a charity. Because charitable bequests are deductible against the estate tax, the after-tax cost of a charitable bequest is lower than the after-tax cost of a transfer to an heir who is not a spouse.[1634] Economists refer to this incentive as the "price" or "substitution effect." In short, the price effect says that if something is made cheaper, people will do more of it. Some analysts have suggested that the charitable estate tax deduction creates a strong incentive to make charitable bequests and that changes in Federal estate taxation could alter the amount of funds that flow to charitable purposes. The decision to make a charitable bequest arises not only from the incentive effect of a charitable bequest's deductibility, or "tax price," but also from what economists call the "wealth effect." Generally the wealthier an individual is, the more likely he or she is to make a charitable bequest and the larger the bequest will be. Because the estate tax diminishes the amount of wealth available to an heir, the wealth effect would suggest repeal of the estate tax could increase charitable bequests.

A number of studies have examined the effects of estate taxes on charitable bequests. Most of these studies have concluded that, after controlling for the size of the estate and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable

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[1633] Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," 82 *American Economic Review* (June 1992), and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," 82 *American Economic Review* (June 1992). These studies, however, examine data relating to a broad range of incomes in the United States and do not directly assess the correlation of income among family members with transferors subject to the estate tax.

[1634] Economists note that when expenditures on specified items are permitted to be deducted from the tax base, before the computation of tax liability, the price of the deductible item is effectively reduced by a percentage equal to the taxpayer's marginal tax rate. Assume, for example, a decedent has a $1 million taxable estate and that the marginal, and average, estate tax rate was 45 percent. This means that the estate tax liability would be $450,000. A net of $550,000 would be available for distribution to heirs. If, however, the decedent had provided that his estate make a charitable bequest of $100,000, the taxable estate would equal $900,000 and the estate tax liability would be $405,000. By bequeathing $100,000 to charity, the estate's tax liability fell by $45,000. The net available for distribution to heirs after payment of the estate tax and payment of the charitable bequest would be $495,000. The $100,000 charitable bequest reduced the amount of funds available to be distributed to heirs by only $55,000. Economists say that the $100,000 charitable bequest "cost" $55,000, or that the "price" of the bequest was 55 cents per dollar of bequest. More generally, the "price" of charitable bequest equals (1 - t), where t is the estate's marginal tax rate.

bequests.[1635] Some analysts interpret these findings as implying that reductions in estate taxation, as under the budget proposal, could lead to a reduction in funds flowing into the charitable sector. This is not necessarily the case, however. Some charitable bequests may substitute for lifetime giving to charity, in part to take advantage of the greater value of the charitable deduction under the estate tax than under the income tax that results from the lower marginal income tax rates and limitations on annual lifetime giving. If this is the case, reductions in the estate tax could lead to increased charitable giving during the taxpayer's life. On the other hand, some analysts have suggested that a more sophisticated analysis is required recognizing that a taxpayer may choose among bequests to charity, bequests to heirs, lifetime gifts to charity, and lifetime gifts to heirs and recognizing that lifetime gifts reduce the future taxable estate and consumption. In this more complex framework, reductions in estate taxation could reduce lifetime charitable gifts.[1636]

Federal transfer taxes and complexity

Critics of Federal transfer taxes document that these taxes create incentives to engage in avoidance activities. Some of these avoidance activities involve complex legal structures and can be expensive to create. Incurring these costs, while ultimately profitable from the donors' and donees' perspective, is socially wasteful because time, effort, and financial resources are spent that lead to no increase in productivity. Such costs represent an efficiency loss to the economy in addition to whatever distorting effects Federal transfer taxes may have on other economic choices such as saving and labor supply discussed above. For example, in the case of family-owned businesses, such activities may impose an ongoing cost by creating a business structure to reduce transfer tax burdens that may not be the most efficient business structure for the operation of the business. Reviewing more complex legal arrangements increases the administrative cost of the Internal Revenue Service. There is disagreement among analysts regarding the magnitude of the costs of avoidance activities.[1637] It is difficult to measure the

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[1635] For example, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* Chicago: University of Chicago Press, 1985; David Joulfaian, "Charitable Bequests and Estate Taxes," 44 *National Tax Journal* (June 1991), pp. 169-180; and Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," 59 *Journal of Public Economics* (1996), pp. 55-68. David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," 53 *National Tax Journal* (September 2000), pp. 743-763, provides a survey of these studies and presents new evidence. Each of these studies estimates a tax price elasticity in excess of 1.6 in absolute value. This implies that for each 10-percent reduction in the tax price, where the tax price is defined as one minus the marginal tax rate, there is a greater than 16-percent increase in the dollar value of charitable bequests. Such a finding implies that charities receive a greater dollar value of bequests than the Treasury loses in forgone tax revenue. In a more recent study, Michael J. Brunetti, "The Estate Tax and Charitable Bequests: Elasticity Estimates Using Probate Records," 58 *National Tax Journal* (June 2005), pp. 165-188, finds price elasticities in excess of 1.2.

Not all studies find such responsiveness of charitable bequests to the marginal estate tax rate. Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," 37 *National Tax Journal* (June 1984), pp. 225-237, estimated that marginal tax rates had no effect on charitable bequests.

[1636] Auten and Joulfaian, "Charitable Contributions and Intergenerational Transfers," attempted to estimate this more complex framework. Their findings suggest that reductions in estate taxation would reduce charitable contributions during the taxpayer's life.

[1637] Joint Economic Committee, "The Economics of the Estate Tax," December 1998, has stated "the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised." Richard Schmalbeck,

extent to which any such costs incurred are undertaken from tax avoidance motives as opposed to succession planning or other motives behind gifts and bequests.

Alternatives to the current U.S. estate tax system

Some argue that, rather than modifying and making permanent the present U.S. estate tax system, Congress should consider an alternative structure. The choice of one form of wealth transfer tax system over another necessarily will involve tradeoffs among efficiency, equity, administrability, and other factors. A determination whether one system is preferable to another could be made on the basis of each system's relative success in achieving one or a majority of these goals, without sacrificing excessively the achievement of the others. Alternatively, such a determination could be made based on which system provides the best mix of efficiency, equity, and administrability.

The United States, State governments, and foreign jurisdictions tax transfers of wealth in many different ways. Some wealth transfer tax systems, for example, impose a tax on the transferor. Such systems include the U.S. estate and gift tax system, which imposes a gift tax on certain gratuitous lifetime transfers, an estate tax on a decedent's estate, and a generation skipping transfer tax on certain transfers that skip generations. Another approach that involves imposition of a tax on a transferor is a "deemed-realization" approach, under which a gratuitous transfer is treated as a realization event and the gain on transferred assets, if any, generally is taxed to the transferor as capital gain.

Other wealth transfer tax systems tax the transferee of a gift or bequest.[1638] Such systems include inheritance (or "accessions") tax systems, under which a tax is imposed against the recipient of a gratuitous transfer. Some jurisdictions do not impose a separate tax, but instead treat receipts of gifts or bequests as gross income of the recipient (an "income inclusion approach").

Regardless of whether the tax is imposed against the transferor or the transferee, some commentators assert that the real economic burden of any approach to taxing transfers of wealth falls on the recipients, because the amount received effectively is reduced by the amount of tax paid by the transferor or realized by the transferee.[1639] Some commentators argue that systems

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"Avoiding Federal Wealth Transfer Taxes," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, Washington, D.C.: The Brookings Institution (2001), disagrees writing "[a]bout half of the estate planners consulted in the preparation of this paper reported that they had rather standard packages that they would make available to individuals who would leave estates in the three to ten million range that might be provided for as little as $3000 to $5000." See William G. Gale and Joel B. Slemrod, "Life and Death Questions About the Estate and Gift Tax," 53 *National Tax Journal* (December 2000), pp. 889-912, for a review of the literature on compliance cost.

[1638] Eight states have some form of Inheritance Tax. See McGuire Woods LLP, 2011 State Death Tax Chart (Revised March 3, 2011), available at *http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf*.

[1639] See, e.g., Lily L. Batchelder, "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax," The Hamilton Project, The Brookings Institution, Discussion Paper 2007-07, p. 5 (June 2007); "Alternatives to the Current Wealth Transfer Tax System," in American Bar Association, Task Force on Federal

that impose a tax based on the circumstances of the transferee –such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries. Others assert that such systems promote fairness in the tax system. However, the extent to which one form of transfer tax system in practice is more effective than another in achieving these goals is not clear.

Wealth transfer tax systems other than an estate tax also may present benefits or additional challenges in administration or compliance. Inheritance taxes or income inclusion systems, for example, may reduce the need for costly tax planning in the case of certain transfers between spouses. At the same time, to the extent such systems are effective in encouraging distributions to multiple recipients in lower tax brackets, they may be susceptible to abuse such as through the use of multiple nominal recipients as conduits for a transfer intended for a single beneficiary.

Prior Action

The President's fiscal year 2010 and 2011 budget proposals contained similar proposals.

Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes 171 app. A (2004); Joseph M. Dodge, "Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax," 56 *SMU Law Review* (2003), pp. 551, 556.

J. Index the Individual Alternative Minimum Tax Amounts for Inflation

Present Law

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of the excess of alternative minimum taxable income ("AMTI") over the AMT exemption amount and (2) 28 percent of the remaining excess. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The exemption amounts are: (1) $74,450 ($45,000 in taxable years beginning after 2011) in the case of married individuals filing a joint return and surviving spouses; (2) $48,450 ($33,750 in taxable years beginning after 2011) in the case of other unmarried individuals; (3) $37,225 ($22,500 in taxable years beginning after 2011) in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits. These credit include the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit.

For taxable years beginning before 2012, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2011, the nonrefundable personal credits (other than the adoption credit, the child credit, the Hope Scholarship credit (for taxable years beginning after 2012), the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, and the credit for new qualified plug-in electric drive motor vehicles) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, the child credit, the Hope Scholarship credit (for taxable years beginning before 2013), the credit for savers, the credit for residential energy efficient property, the credit certain plug-in electric vehicles, the credit for

alternative motor vehicles, and the credit for new qualified plug-in electric drive motor vehicles are allowed to the full extent of the individual's regular tax and alternative minimum tax.[1640]

Description of Proposal

The proposal provides that the individual AMT exemption amounts, including the thresholds for the phaseout of the exemption amounts, are indexed for inflation from the levels in effect for 2011. The proposal indexes the threshold amounts for the beginning of the 28-percent bracket.

The proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective date.–The proposal is effective for taxable years beginning after 2011.

Analysis

Allowing the nonrefundable personal credits to offset the regular tax and alternative minimum tax, and increasing the exemption amounts, will substantially reduce the number of taxpayers affected by the AMT. In addition to the reduction in tax liability as a result of this change, there will be significant simplification benefits. Substantially fewer taxpayers will need to complete the alternative minimum tax form (Form 6251), and the forms and worksheets relating to the various credits can be simplified.

By permanently establishing the AMT exemption levels and ability to take nonrefundable credits against the AMT, the proposal provides greater certainty for taxpayers as to their tax obligation resulting from the AMT, in comparison to the practice over the past years of annually adjusting the exemption levels to prevent their reversion to the levels in effect prior to EGTRRA. Additionally, by indexing the AMT system for inflation, as is done in the regular tax system, the proposal prevents tax increases in real terms for the portion of one's income growth that merely accounts for inflationary growth. By doing so, the proposal substantially slows the rate of growth in the number of taxpayers subject to the AMT over time.

A number of analysts argue that the proposal does not go far enough, advocating instead the abolition of the AMT. Their argument rests on the observation that the AMT system has outlived its original purpose of requiring taxpayers engaged in substantial sheltering of income to pay at least some minimum tax. Instead, taxpayers today are mainly ensnared by the AMT as a result of their income level, payment of state and local taxes, and presence of dependents. Such analysts argue that requiring such taxpayers to calculate their liability two ways is needlessly complex and serves no discernible policy objective that the regular tax alone couldn't provide.

[1640] The rule applicable to the child credit after 2012 is subject to the EGTRRA sunset. The adoption credit is refundable in 2011 and beginning in 2012 is nonrefundable and treated in the same manner as the child credit.

APPENDIX: MARCH 2011 ESTIMATES OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2012 BUDGET PROPOSAL

The Joint Committee staff provided the following estimates of the proposals described within this document on March 17, 2011. Over time the Joint Committee staff has had the opportunity to update information and refine the modeling of a number of the proposals. Consequently, the following estimates may not reflect the assessments of the budgetary effect of the proposals that may be made by the Joint Committee staff over the remainder of the first session of the 112th Congress.

APPENDIX:
MARCH 2011 ESTIMATES OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2012 BUDGET PROPOSAL [1]

Fiscal Years 2011 - 2021

[Millions of Dollars]

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
I. Index to Inflation the 2011 Parameters of the AMT……..	**tyba 12/31/11**	**---**	**-9,047**	**-92,794**	**-39,497**	**-45,422**	**-53,069**	**-61,839**	**-73,051**	**-86,749**	**-102,158**	**-119,366**	**-239,830**	**-682,993**
II. Make Permanent and Modify Certain Tax Cuts Enacted in 2001 and 2003														
A. Marginal Individual Income Tax Rate Reductions														
1. Retain 10% income tax bracket [2].....	tyba 12/31/12	---	---	-44,100	-64,873	-67,626	-70,562	-73,498	-76,745	-80,132	-83,462	-86,990	-247,161	-647,988
2. Retain the 25%, 28%, and part of the 33% income tax brackets.....	tyba 12/31/12	---	---	-34,169	-51,389	-54,788	-58,544	-62,452	-67,027	-71,699	-76,238	-81,042	-198,889	-557,348
B. Marriage Penalty Relief and Earned Income Tax Credit Simplification														
1. Standard deduction and 15% rate bracket set at 2 times single for married filing jointly [2].....	tyba 12/31/12	---	---	-20,893	-31,054	-32,326	-33,855	-37,407	-37,881	-38,814	-40,802	-42,630	-118,128	-315,662
2. EITC modification and simplification - increase in joint returns beginning and ending income level for phase-out by $5,000 indexed after 2008; simplify definition of earned income; use AGI instead of modified AGI; simplify definition of qualifying child and tie-breaker rules; and allow math error procedure with Federal Case registry data beginning in 2004 [2].....	tyba 12/31/12	---	---	-46	-4,610	-4,673	-4,784	-4,870	-4,973	-5,067	-5,154	-5,224	-14,114	-39,402
C. Child Tax Credit - retain the child tax credit at $1,000; refundable up to greater of 15% of earned income in excess of $10,000 (indexed from 2001) or the taxpayer's social security tax liability to the extent that it exceeds the taxpayer's earned income credit; allow credit against the AMT; repeal AMT offset of refundable credits [2].....	tyba 12/31/12	---	---	-2,681	-28,510	-28,850	-29,286	-29,494	-29,656	-29,754	-29,766	-29,706	-89,327	-237,703

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
D. Other Incentives for Families and Children														
1. Dependent care tax credit - increase the credit rate to 35%, increase the eligible expenses to $3,000 for one child and $6,000 for two or more children (not indexed), and increase the start of the phase-out to $15,000 of AGI [2]	tyba 12/31/12	---	---	-169	-681	-697	-712	-726	-736	-747	-756	-765	-2,259	-5,987
2. Adoption credit - increase the expense limit and the exclusion to $10,000 for both non-special needs and special needs adoptions, make the credit independent of expenses for special needs adoptions, extend the credit and the exclusion, increase the phase-out start point to $150,000, index for inflation the expenses limit and the phase-out start point for both the credit and the exclusion, and allow the credit to apply to the AMT [2]	tyba 12/31/12	---	---	-88	-295	-302	-305	-313	-323	-332	-343	-356	-990	-2,657
3. Employer-provided child care credit of 25% for child care expenditures and 10% for child care resource	tyba 12/31/12	---	4	-16	-19	-21	-23	-24	-25	-25	-26	-27	-75	-202
E. Repeal Overall Limitation on Itemized Deduction and the Personal Exemption Phase-out for Certain Taxpayers	tyba 12/31/12	---	---	-966	-2,038	-2,243	-2,452	-2,675	-2,922	-3,178	-3,414	-3,656	-7,699	-23,544
F. Education Incentives														
1. Coverdell Education Savings Accounts ("ESAs") - increase the annual contribution limit to $2,000; allow ESA contributions for special needs beneficiaries above the age of 18; allow corporations and other entities to contribute to ESAs; allow contributions until April 15 of the following year; allow a taxpayer to exclude ESA distributions from gross income and claim the HOPE or Lifetime Learning credits as long as they are not used for the same expenses; repeal excise tax on contributions made to ESA when contribution made by anyone on behalf of same beneficiary to QTP; modify phase-out range for married taxpayers; allow tax-free expenditures for elementary and secondary school expenses; expand the definition of qualified expenses to include certain computers and related items	tyba 12/31/12	---	---	-11	-17	-22	-29	-35	-42	-50	-59	-68	-79	-334
2. Employer provided educational assistance - extend the exclusion for undergraduate courses and graduate level courses [3]	cba 12/31/12	---	---	-750	-1,022	-1,053	-1,085	-1,117	-1,151	-1,185	-1,221	-1,257	-3,910	-9,841

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
3. Student loan interest deduction - eliminate the 60-month rule and the disallowance for voluntary payments; increase phase-out ranges to $50,000-$65,000 single/ $100,000-$130,000 joint, indexed for inflation	ipa 12/31/12	---	---	-66	-657	-678	-754	-755	-797	-771	-849	-900	-2,155	-6,226
4. Eliminate the tax on awards under the National Health Service Corps Scholarship program and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program	tyba 12/31/12	---	---	-9	-37	-38	-40	-41	-42	-44	-46	-47	-124	-344
5. Increase arbitrage rebate exception for governmental bonds used to finance qualified school construction from $10 million to $15 million	bia 12/31/12	---	---	-2	-5	-7	-9	-11	-13	-15	-17	-19	-23	-98
6. Issuance of tax-exempt private activity bonds for qualified education facilities with annual State volume caps the greater of $10 per resident or $5 million	bia 12/31/12	---	---	-1	-3	-7	-11	-17	-22	-27	-32	-37	-22	-157
G. Reduce the Earnings Threshold for the Refundable Portion of the Child Tax Credit to $3,000 [2]	tyba 12/31/12	---	---	-1	-10,258	-10,169	-10,095	-9,993	-9,961	-9,838	-9,778	-9,751	-30,519	-79,840
H. Tax Capital Gains with a 0%/15% Rate Structure for Taxpayers with Income Below $250,000 (Joint) and $200,000 (Single)	tyba 12/31/12	---	-273	-1,666	-1,343	-4,540	-4,646	-4,737	-4,875	-5,064	-5,241	-5,430	-12,467	-37,815
I. Tax Dividends with a 0%/15% Rate Structure for Taxpayers with Income Below $250,000 (Joint) and $200,000 (Single)	tyba 12/31/12	---	-557	-3,329	-9,080	-9,292	-9,507	-9,740	-10,045	-10,268	-10,412	-10,607	-31,764	-82,837
J. Section 179 Expensing Amounts and Threshold Limits $125,000/$500,000	tyba 12/31/12	---	---	-4,063	-7,133	-5,538	-4,561	-3,804	-3,154	-2,785	-2,689	-2,757	-21,294	-36,484
K. Make Permanent the Estate, Gift, and Generation-Skipping Transfer Taxes; Extend 2009 Law; Gift Tax Lifetime Exclusion to Remain at $1 Million	dda & gma 12/31/12	---	-336	-678	-21,485	-25,160	-27,212	-29,106	-30,906	-32,734	-34,604	-36,585	-74,872	-238,807
Total of Make Permanent and Modify Certain Tax Cuts Enacted in 2001 and 2003		**---**	**-1,162**	**-113,704**	**-234,509**	**-248,030**	**-258,472**	**-270,815**	**-281,296**	**-292,529**	**-304,909**	**-317,854**	**-855,871**	**-2,323,276**
III. Tax Cuts for Families and Individuals														
A. Provide $250 Refundable Tax Credit for Federal, State and Local Government Retirees not Eligible for Social Security [2]	DOE	-166	-663	---	---	---	---	---	---	---	---	---	-828	-828
B. Extend the Earned Income Tax Credit ("EITC") for Larger Families [2]	tyba 12/31/12	---	---	-18	-1,822	-1,825	-1,854	-1,880	-1,913	-1,937	-1,971	-2,004	-5,520	-15,224
C. Expand the Child and Dependent Care Tax Credit [2]	tyba 12/31/11	---	-278	-1,125	-1,156	-1,155	-1,156	-1,158	-1,157	-1,157	-1,159	-1,152	-4,870	-10,654
D. Provide for Automatic Enrollment in Individual Retirement Accounts or Annuities ("IRAs") and Double the Tax Credit for Small Employer Plan Startup Costs [2]	tyba 12/31/12	---	---	-225	-915	-987	-1,063	-1,159	-1,260	-1,359	-1,447	-1,536	-3,189	-9,950

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
E. Extend American Opportunity Tax Credit ("AOTC") [2]	tyba 12/31/12	---	---	-2,074	-10,370	-10,393	-10,524	-10,796	-10,975	-11,460	-11,678	-12,079	-33,361	-90,349
F. Provide Exclusion from Income for Certain Student Loan Forgiveness	lfa 12/31/11	---	---	---	---	---	---	---	---	[4]	[4]	[4]	---	[4]
G. Tax Qualified Dividends at a 20-Percent Rate for Upper-Income Taxpayers	tyba 12/31/12	---	-338	-2,830	-8,387	-9,085	-9,844	-11,328	-12,759	-13,485	-13,610	-14,119	-30,484	-95,785
Total of Tax Cuts for Families and Individuals		**-166**	**-1,279**	**-6,272**	**-22,650**	**-23,445**	**-24,441**	**-26,321**	**-28,064**	**-29,398**	**-29,865**	**-30,890**	**-78,252**	**-222,790**
IV. Tax Cuts for Businesses														
A. Eliminate Capital Gains Taxation on Investments in Small Business Stock	qsbsaa 12/31/11	---	-5	18	31	41	54	80	-852	-1,318	-1,497	-1,661	139	-5,109
B. Enhance and Make Permanent the Research and Experimentation ("R&E") Tax Credit	tyba 12/31/11	---	-3,184	-5,547	-6,543	-7,537	-8,501	-9,425	-10,324	-11,234	-12,169	-13,129	-31,313	-87,594
C. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project (“48C”)	DOE	-829	-1,489	-858	-348	-248	-79	81	105	53	11	---	-3,850	-3,600
D. Provide Tax Credit for Energy-Efficient Commercial Building Property Expenditures in Place of Existing Tax Deduction and Provide REIT benefits	ppisd cy 2012	---	-428	-388	-165	-123	-84	-23	-2	3	5	3	-1,186	-1,199
Total of Tax Cuts for Businesses		**-829**	**-5,106**	**-6,775**	**-7,025**	**-7,867**	**-8,610**	**-9,287**	**-11,073**	**-12,496**	**-13,650**	**-14,787**	**-36,210**	**-97,502**
V. Incentives to Promote Regional Growth														
A. Extend and Modify the New Markets Tax Credit ("NMTC")	DOE	-2	-11	-46	-115	-220	-293	-326	-351	-359	-318	-254	-687	-2,295
B. Reform and Extend Build America Bonds [2]	bia DOE	-5	-47	-147	-261	-374	-492	-617	-746	-876	-1,007	-1,138	-1,324	-5,709
C. Low-Income Housing Tax Credit ("LIHTC") Provisions														
1. Encourage mixed-income occupancy by allowing LIHTC-supported projects to elect an average-income criterion	[5]	[4]	-1	-5	-7	-14	-22	-29	-37	-44	-52	-60	-49	-271
2. Provide 30-percent basis “boost” to properties that receive tax-exempt bond financing	[6]	[4]	-3	-9	-14	-26	-37	-50	-62	-75	-88	-101	-90	-465
D. Designate Growth Zones	1/1/2012	---	-250	-668	-811	-767	-726	-142	297	258	215	153	-3,222	-2,441
E. Restructure Assistance to New York City - Provide Tax Incentives for Transportation Infrastructure [2]	tyba 12/31/11	---	-200	-200	-200	-200	-200	-200	-200	-200	-200	-200	-1,000	-2,000
Total of Incentives to Promote Regional Growth		**-7**	**-512**	**-1,075**	**-1,408**	**-1,601**	**-1,770**	**-1,364**	**-1,099**	**-1,296**	**-1,450**	**-1,600**	**-6,372**	**-13,181**

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
VI. Continue Certain Expiring Provisions Through Calendar Year 2012														
A. Energy														
1. Incentives for biodiesel and renewable diesel (sunset 12/31/12)	fsoua 12/31/11	---	-810	-300	---	---	---	---	---	---	---	---	-1,110	-1,110
2. Credit for construction of energy efficient new homes (sunset 12/31/12)	haa 12/31/11	---	-62	-45	-16	-15	-13	-11	-9	-3	---	---	-151	-175
3. Incentives for alternative fuel and alternative fuel mixtures (sunset 12/31/12)	fsoua 12/31/11	---	-123	-40	---	---	---	---	---	---	---	---	-163	-163
4. Special rule to implement electric transmission restructuring (sunset 12/31/12)	Da 12/31/11	---	-244	-96	54	54	54	54	54	54	19	---	-180	---
5. Grants for specified energy property in lieu of tax credits (sunset 12/31/12) [2]	ppisa 12/31/11	---	-1,281	-744	-198	2	147	150	151	151	151	158	-2,074	-1,312
6. Incentives for alcohol fuels														
a. Extension of income tax credit for alcohol used as fuel; extension of excise tax credit for alcohol used as fuel; extension of payment for alcohol fuel mixture (sunset 12/31/12)	pa 12/31/11 & saua 12/31/11	---	-4,033	-1,486	---	---	---	---	---	---	---	---	-5,519	-5,519
b. Extension of additional duties on ethanol (sunset 12/31/12) [7]	1/1/12	---	14	5	---	---	---	---	---	---	---	---	19	19
7. Extension of section 25C nonbusiness energy property (sunset 12/31/12)	ppisa 12/31/11	---	-122	-488	---	---	---	---	---	---	---	---	-610	-610
8. Credit for energy efficient appliances (sunset 12/31/12)	apa 12/31/11	---	-38	-36	-24	-24	-24	-24	-24	-24	-16	-4	-145	-235
9. Alternative fuel vehicle refueling property (non-hydrogen refueling property) (sunset 12/31/12)	ppisa 12/31/11	---	-7	-6	-2	-1	-1	[8]	[8]	[8]	[8]	[8]	-18	-17
B. Individual Tax Relief														
1. Above-the-line deduction of up to $250 for teacher classroom expenses (sunset 12/31/12)	tyba 12/31/11	---	-41	-165	---	---	---	---	---	---	---	---	-206	-206
2. Deduction of State and local general sales taxes (sunset 12/31/12)	tyba 12/31/11	---	-300	-2,123	-266	---	---	---	---	---	---	---	-2,689	-2,689
3. Contributions of capital gain real property made for qualified conservation purposes (sunset 12/31/12)	cmi tyba 12/31/11	---	-41	-26	-5	1	5	-9	-13	-11	-10	-9	-65	-117
4. Deduction for qualified tuition and related expenses (sunset 12/31/12)	tyba 12/31/11	---	-157	-629	---	---	---	---	---	---	---	---	-786	-786
5. Tax-free distributions from IRAs to certain public charities for individuals age 70 1/2 or older, not to exceed $100,000 per taxpayer per year; distributions made in January 2011 may count against the 2010 $100,000 limit and satisfy the 2010 minimum distribution requirement (sunset 12/31/12)	dmi tyba 12/31/11	---	-163	-173	-22	-23	-24	-26	-28	-30	-32	-35	-405	-556

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
6. Estate tax look-through for certain RIC stock held by nonresidents (sunset 12/31/12)	dda 12/31/11	---	-5	-3	---	---	---	---	---	---	---	---	-8	-8
7. Parity for exclusion for employer-provided mass transit and parking benefits (sunset 12/31/12)	ma 12/31/11	---	-119	-40	---	---	---	---	---	---	---	---	-158	-158
C. Business Tax Relief														
1. Indian employment tax credit (sunset 12/31/12)	tyba 12/31/11	---	-20	-28	-9	-1	---	---	---	---	---	---	-56	-56
2. 50% tax credit for certain expenditures for maintaining railroad tracks (sunset 12/31/12)	epoid tyba 12/31/11	---	-66	-99	[4]	---	---	---	---	---	---	---	-166	-166
3. Mine rescue team training credit (sunset 12/31/12)	tyba 12/31/11	---	-1	-1	[4]	[4]	[4]	[4]	[4]	---	---	---	-2	-2
4. Employer wage credit for activated military reservists (sunset 12/31/12)	pma 12/31/11	---	-3	-3	-1	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-7	-7
5. 15-year straight line cost recovery for qualified leasehold, restaurant and retail improvements (sunset 12/31/12)	ppisa 12/31/11	---	-109	-304	-388	-386	-381	-371	-364	-360	-349	-326	-1,568	-3,339
6. 7-year recovery period for certain motorsports racing track facilities (sunset 12/31/12)	ppisa 12/31/11	---	-15	-9	-5	-3	-1	-2	-2	1	3	3	-33	-29
7. Accelerated depreciation for business property on Indian reservations (sunset 12/31/12)	ppisa 12/31/11	---	-73	-135	-67	-11	2	40	62	42	5	-8	-284	-143
8. Enhanced charitable deduction for contributions of food inventory (sunset 12/31/12)	cma 12/31/11	---	-104	-35	---	---	---	---	---	---	---	---	-138	-138
9. Enhanced charitable deduction for contributions of book inventories to public schools (sunset 12/31/12)	cma 12/31/11	---	-45	-15	---	---	---	---	---	---	---	---	-60	-60
10. Enhanced charitable deduction for corporate contributions of computer inventory for educational purposes (sunset 12/31/12)	cmd tyba 12/31/11	---	-180	-60	---	---	---	---	---	---	---	---	-240	-240
11. Election to expense mine safety equipment (sunset 12/31/12)	ppisa 12/31/11	---	-18	-4	6	4	3	3	3	2	1	---	-8	---
12. Special expensing rules for certain film and television productions (sunset 12/31/12)	qfatpca 12/31/11	---	-41	-183	24	20	17	14	10	6	5	4	-163	-124
13. Expensing of "Brownfields" environmental remediation costs (sunset 12/31/12)	epoia 12/31/11	---	-217	-134	20	24	28	25	22	20	16	14	-279	-184
14. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sunset 12/31/12)	tyba 12/31/11	---	-45	-156	---	---	---	---	---	---	---	---	-201	-201
15. Modify tax treatment of certain payments under existing arrangements to controlling exempt organizations (sunset 12/31/12)	proaa 12/31/11	---	-15	-5	---	---	---	---	---	---	---	---	-21	-21
16. Treatment of certain dividends of regulated investment companies ("RICs") (sunset 12/31/12)	[9]	---	-13	-91	---	---	---	---	---	---	---	---	-104	-104
17. Extend the treatment of RICs as "qualified investment entities" under section 897 ("FIRPTA") (sunset 12/31/12)	1/1/11	-9	-29	-25	---	---	---	---	---	---	---	---	-63	-63

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
18. Exception under subpart F for active financing income (sunset 12/31/12)	tyba 12/31/11	---	-2,081	-3,129	---	---	---	---	---	---	---	---	-5,210	-5,210
19. Look-through treatment of payments between related CFCs under foreign personal holding company income rules (sunset 12/31/12)	tyba 2011	---	-312	-463	---	---	---	---	---	---	---	---	-775	-775
20. Basis adjustment to stock of S corporations making charitable contributions of property (sunset 12/31/12)	cmi tyba 12/31/11	---	-15	-20	-7	-4	-4	-4	-4	-4	-4	-4	-50	-70
21. Tax incentives for investment in the District of Columbia (sunset 12/31/12)	pa 12/31/11	---	-10	-11	-13	-22	-22	-25	-25	-20	-19	-19	-78	-185
22. Temporary increase in limit on cover over of rum excise tax revenues (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands (sunset 12/31/12) [2] [7]	abiUSa 12/31/11	---	-107	-24	---	---	---	---	---	---	---	---	-131	-131
23. Economic development credit for American Samoa (sunset 12/31/12)	tyba 12/31/11	---	-9	-10	---	---	---	---	---	---	---	---	-19	-19
24. Work opportunity tax credit (sunset 12/31/12)	wpoifibwa 12/31/11	---	-281	-421	-159	-59	-33	-16	-2	---	---	---	-953	-971
25. Qualified zone academy bonds ($400 million allocation) (sunset 12/31/12)	oia 12/31/11	---	[4]	-2	-7	-14	-19	-19	-18	-17	-16	-14	-42	-126
26. Premiums for mortgage insurance deductible as interest that is qualified residence interest (sunset 12/31/12)	apoaa 12/31/11	---	-185	-554	---	---	---	---	---	---	---	---	-739	-739
D. Temporary Disaster Provisions														
1. New York Liberty Zone - tax exempt bond financing (sunset 12/31/12)	bia 12/31/11	---	-4	-6	-6	-6	-6	-6	-6	-6	-6	-6	-28	-58
2. GO Zone:														
a. Extend the higher credit rate for GO Zone rehabilitation (sunset 12/31/12)	apoia 12/31/11	---	-7	-22	-7	1	1	2	2	2	2	2	-34	-24
b. Extend the placed-in-service deadline for GO zone low-income housing credits (sunset 12/31/12)	ppisa 12/31/11	---	-5	-20	-20	-20	-20	-20	-20	-20	-20	-20	-85	-185
c. Tax-exempt bond financing (sunset 12/31/12)	bia 12/31/11	---	-3	-11	-16	-16	-16	-16	-15	-15	-15	-14	-62	-137
d. Bonus depreciation for specified GO Zone extension property (sunset 12/31/12)	ppisa 12/31/11	---	-154	-88	-5	-2	2	4	6	7	9	11	-247	-210
E. Other Tax Provisions														
1. Patient Protection and Affordable Care Act expansion of the adoption credit (sunset 12/31/12) [2]	tyba 12/31/11	---	-237	-548	17	6	---	---	---	---	---	---	-762	-762
2. Plug-in hybrid conversion credit (sunset 12/31/12)	ppisa 12/31/11	---	---	-2	---	---	---	---	---	---	---	---	-2	-2
3. LIHTC treatment of military housing allowances (sunset 12/31/12)	dA 12/31/11	---	[4]	-2	-3	-3	-3	-3	-3	-3	-3	-3	-11	-26
4. Qualified green building and sustainable design project bonds (sunset 12/31/12)	bia 9/30/12	---	[4]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
5. Health coverage tax credit ("HCTC") (sunset 12/31/12) [2] [10]	[11]	-68	-120	-51	-15	-14	-13	-13	-12	-12	-11	-11	-281	-340
F. Extend Trade Provisions														
1. Renew Andean Trade Preferences (sunset 12/31/12) [7]	2/12/11	-46	-75	-19	---	---	---	---	---	---	---	---	-140	-140
2. Extension of Generalized System of Preferences (sunset 12/31/12) [7]	1/1/11	-412	-568	-144	---	---	---	---	---	---	---	---	-1,124	-1,124
Total of Continue Certain Expiring Provisions Through Calendar Year 2012		**-535**	**-12,699**	**-13,230**	**-1,141**	**-513**	**-322**	**-274**	**-236**	**-241**	**-291**	**-282**	**-28,437**	**-29,759**
VII. Other Revenue Changes and Loophole Closers														
A. Reform Treatment of Financial Institutions and Products														
1. Impose a financial crisis responsibility fee	da 12/31/12	*Proposal Requires Additional Specification*												
2. Require accrual of income on forward sale of corporate stock	ceia 12/31/11	---	1	4	7	10	13	16	19	22	25	29	35	146
3. Require ordinary treatment of income from day-to-day dealer activities for certain dealers of equity options and commodities	tyba DOE	29	182	265	269	282	294	307	320	332	344	357	1,321	2,980
4. Modify the definition of "control" for purposes of section 249 of the Internal Revenue Code	DOE	2	7	7	8	8	8	9	9	10	10	11	40	88
B. Reinstate Superfund Taxes														
1. Reinstate superfund excise taxes (sunset 12/31/21)	pa 12/31/11	---	496	667	669	669	670	671	670	668	668	671	3,171	6,519
2. Reinstate superfund environmental income tax (sunset 12/31/21)	tyba 12/31/11	---	658	1,245	1,334	1,328	1,340	1,354	1,366	1,383	1,414	1,462	5,905	12,884
C. Reform U.S. International Tax System														
1. Defer deduction of interest expense related to deferred income	tyba 12/31/11	---	1,957	3,751	3,976	4,214	4,467	4,735	5,019	5,320	5,640	3,587	18,365	42,666
2. Determine the foreign tax credit on a pooling basis	tyba 12/31/11	---	2,668	5,602	4,655	4,941	5,188	5,448	5,720	6,000	6,306	6,621	23,054	53,149
3. Tax currently excess returns associated with transfers of intangibles offshore	tyba 12/31/11	---	587	1,261	1,318	1,377	1,439	1,504	1,572	1,643	1,717	1,793	5,982	14,211
4. Limit shifting of income through intangible property transfers	tyba 12/31/11	---	26	52	54	56	58	60	62	64	66	68	246	566
5. Disallow the deduction for non-taxed reinsurance premiums paid to affiliates	pii tyba	---	394	928	942	1,019	1,104	1,142	1,312	1,472	1,622	1,824	4,387	11,759
6. Limit earnings stripping by expatriated entities	tyba 12/31/11	---	---	72	160	168	176	185	194	204	214	225	576	1,598
7. Modify the tax rules for dual capacity taxpayers	tyba 12/31/11	---	341	837	871	905	942	979	1,018	1,059	1,102	1,147	3,896	9,201
D. Reform Treatment of Insurance Companies and Products														
1. Modify Rules that apply to sales of life insurance contracts	[12]	---	24	44	57	71	86	102	120	140	161	185	281	990

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
2. Modify dividends-received deduction ("DRD") for life insurance company separate accounts	tyba 12/31/11	---	255	409	435	464	497	524	551	579	602	625	2,058	4,940
3. Expand pro rata interest expense disallowance for corporate-owed life insurance	[13]	---	101	246	381	511	637	759	877	992	1,104	1,215	1,876	6,824
E. Miscellaneous Changes														
1. Increase the Oil Spill Liability Trust Fund financing rate to 9 cents per barrel effective 2012 and 10 cents per barrel effective 2017 and thereafter	pa 12/31/11	---	30	47	47	47	47	47	47	47	47	47	218	453
2. Make the 0.2 percent unemployment insurance surtax permanent [7]	7/1/11	82	983	1,386	1,418	1,450	1,477	1,498	1,514	1,531	1,547	1,563	6,796	14,449
3. Provide short-term tax relief to employers and expand Federal Unemployment Tax Act ("FUTA") base [2] [7] [14]	DOE	-1,095	-4,628	-5,551	22,421	20,425	10,217	1,743	-2,882	-1,882	-3,373	-2,435	41,790	32,961
4. Expand short-time compensation unemployment program [2] [7]	DOE	---	-30	-75	-112	-137	-138	-143	-124	-132	-129	-68	-492	-1,088
5. Repeal last-in, first-out ("LIFO") method of accounting for inventories	tyba 12/31/12	---	---	3,858	6,882	7,258	7,492	7,924	8,517	8,858	9,239	9,637	25,490	69,665
6. Repeal gain limitation for dividends received in reorganization exchanges	tyba 12/31/11	---	10	50	50	50	50	50	50	50	50	50	210	460
7. Tax carried (profits) interests in investment partnerships as ordinary income	tyba 12/31/11	424	1,338	1,968	1,892	1,651	1,727	2,177	2,462	2,437	2,332	2,251	9,000	20,659
8. Deny deduction for punitive damages	dpoia 12/31/12	---	---	25	34	35	36	37	38	39	40	42	129	325
9. Repeal lower-of-cost-or-market ("LCM") inventory accounting method	tyba 12/31/12	---	---	99	785	878	654	301	128	20	18	27	2,416	2,910
Total of Other Revenue Changes and Loophole Closers		**-558**	**5,400**	**17,197**	**48,553**	**47,680**	**38,481**	**31,429**	**28,579**	**30,856**	**30,766**	**30,934**	**156,750**	**309,315**
VIII. Eliminate Fossil-Fuel Preferences														
A. Eliminate Oil and Gas Preferences														
1. Repeal enhanced oil recovery ("EOR") credit	tyba 12/31/11	*No Revenue Effect*												
2. Repeal credit for oil and gas produced from marginal wells	tyba 12/31/11	*No Revenue Effect*												
3. Repeal expensing of intangible drilling costs ("IDCs")	cpoia 12/31/11	---	1,016	1,484	1,369	1,256	1,143	924	542	247	177	187	6,268	8,345
4. Repeal deduction for tertiary injectants	apoia 12/31/11	---	7	8	8	8	7	7	6	6	6	5	38	68
5. Repeal exception to passive loss limitation for working interests in oil and natural gas properties	tyba 12/31/11	---	11	22	22	22	22	22	22	22	22	22	99	209
6. Repeal percentage depletion for oil and natural gas wells	tyba 12/31/11	---	605	945	988	1,035	1,084	1,140	1,190	1,232	1,270	1,305	4,657	10,795
7. Repeal domestic manufacturing deduction for oil and natural gas companies	tyba 12/31/11	---	761	1,373	1,442	1,514	1,589	1,668	1,752	1,839	1,932	2,029	6,679	15,899

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
8. Increase geological and small integrated geophysical amortization period for independent producers to seven years	apoia 12/31/11	---	44	157	230	209	157	106	55	22	13	13	796	1,006
B. Eliminate Coal Preferences														
1. Repeal expensing of exploration and development costs	cpoia 12/31/11	---	85	66	47	30	12	4	5	6	7	6	240	268
2. Repeal percentage depletion for coal and hard mineral fossil fuels	tyba 12/31/11	---	71	115	120	124	127	131	141	142	144	147	557	1,262
3. Repeal capital gains treatment for royalties	ari tyba 12/31/11	3	27	68	46	60	63	65	68	71	75	79	266	625
4. Repeal domestic manufacturing deduction for coal and other hard mineral fossil fuels	tyba 12/31/11	---	95	189	200	212	225	239	253	268	284	301	921	2,266
Total of Eliminate Fossil-Fuel Preferences		**3**	**2,722**	**4,427**	**4,472**	**4,470**	**4,429**	**4,306**	**4,034**	**3,855**	**3,930**	**4,094**	**20,521**	**40,743**
IX. Simplify the Tax Code														
A. Allow Vehicle Seller to Claim Qualified Plug-In Electric-Drive Motor Vehicle Credit	vsa 12/31/11	---	-27	5	-13	-30	-32	-42	-33	-28	-44	-31	-97	-276
B. Eliminate Minimum Required Distribution ("MRD") Rules for Individual Retirement Accounts or Annuity ("IRA")/PLAN Balances of $50,000 or Less at Age 70 ½ (or Death if Earlier)	[15]	---	-6	-30	-45	-52	-51	-53	-53	-53	-53	-53	-184	-451
C. Allow all Inherited Plan and IRA or Annuity Balances to be Rolled Over Within 60 Days	DA 12/31/11	*Negligible Revenue Effect*												
D. Clarify Exception to Recapture of Unrecognized Gain on Sale of Stock to an Employee Stock Ownership Plan ("ESOP")	[16]	*Negligible Revenue Effect*												
E. Repeal Non-Qualified Preferred Stock ("NQPS") Designation	sia 12/31/11	---	5	10	10	10	10	10	10	10	10	10	45	95
F. Revise and Simplify the "Fractions Rule"	DOE	-24	-430	-470	-540	-617	-695	-782	-876	-976	-1,086	-1,203	-2,776	-7,699
G. Repeal Preferential Dividend Rule for Publicly Traded Real Estate Investment Trusts ("REITs")	dmi tyba DOE	*Negligible Revenue Effect*												
H. Reform Excise Tax Based on Investment Income of Private Foundations	tyba DOE	---	-25	-35	-36	-38	-39	-40	-42	-43	-44	-46	-173	-387
I. Simplify Tax-Exempt Bonds														
1. Simplify arbitrage investment restrictions	bia DOE	-3	-19	-55	-100	-127	-134	-141	-148	-153	-154	-155	-438	-1,189
2. Simplify single-family housing mortgage bond targeting requirements	bia DOE	[4]	-3	-13	-26	-41	-57	-74	-92	-111	-127	-144	-140	-688
3. Streamline private business limits on Governmental bonds	bia DOE	[4]	-1	-3	-5	-7	-9	-11	-13	-16	-19	-22	-25	-106
Total of Simplify the Tax Code		**-27**	**-506**	**-591**	**-755**	**-902**	**-1,007**	**-1,133**	**-1,247**	**-1,370**	**-1,517**	**-1,644**	**-3,788**	**-10,701**

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
X. Reduce the Tax Gap and Make Reforms														
A. Expand Information Reporting														
1. Repeal and modify information reporting on payments to corporations and payments for property	pma 12/31/11	---	-219	-2,323	-1,664	-1,725	-1,786	-1,931	-2,019	-2,112	-2,207	-2,330	-7,718	-18,317
2. Require information reporting for private separate accounts of life insurance companies	tyba 12/31/11	*Loss of Less than $500,000*												
3. Require a certified taxpayer identification number ("TIN") from contractors and allow certain withholding	pmtca 12/31/11	---	5	45	34	37	40	42	45	48	50	53	162	400
B. Improve Compliance by Businesses														
1. Require greater electronic filing of returns	tyea 12/31/11	*No Revenue Effect*												
2. Authorize the Department of the Treasury to require additional information to be included in electronically filed form 5500 annual reports	pyba 12/31/11	*No Revenue Effect*												
3. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes	[17]	*Negligible Revenue Effect*												
4. Increase certainty with respect to worker classification	DOE	---	55	498	695	801	825	858	887	913	943	971	2,874	7,446
5. Repeal special estimated tax payment provision for certain insurance companies	tyba 12/31/11	*Negligible Revenue Effect*												
6. Eliminate special rules modifying the amount of estimated tax payments by corporations	tyba 12/31/11	---	---	---	-42,015	4,118	37,897	---	---	-4,428	4,428	---	---	---
C. Strengthen Tax Administration														
1. Revise offer-In-compromise application rules	oicsa DOE	-5	-5	[18]	[18]	[18]	[18]	[18]	[18]	[18]	[18]	[18]	-10	-10
2. Expand Internal Revenue Service ("IRS") access to information in the National Directory of New Hires for tax administration purposes	DOE	*No Revenue Effect*												
3. Make repeated willful failure to file a tax return a felony	rrtbfa 12/31/11	*Negligible Revenue Effect*												
4. Facilitate tax compliance with local jurisdictions	dma DOE	*Negligible Revenue Effect*												
5. Extend statute of limitations where State adjustment affects Federal tax liability	rrtbfa 12/31/11	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	1	2
6. Improve investigative disclosure statute	dma DOE	*Negligible Revenue Effect*												
7. Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a 2-D bar code	trfa 12/31/11	*No Revenue Effect*												
8. Require prisons located in the U.S. to provide information to the IRS	DOE	---	6	13	13	13	14	14	15	14	16	16	59	134
9. Allow the IRS to absorb credit and debit card processing fees for certain tax payments	pma DOE	*Negligible Revenue Effect*												

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
D. Expand Penalties														
1. Impose a penalty on failure to comply with electronic filing requirements	rrtbfea 12/31/11	*No Revenue Effect*												
2. Increase penalty imposed on paid preparers who fail to comply with earned income tax credit ("EITC") due diligence requirements	rrtbfa 12/31/11	---	9	19	19	20	20	21	21	22	23	23	87	197
E. Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms														
1. Make permanent the portability of unused exemption between spouses	ddagma 12/31/12	---	---	---	-137	-193	-267	-341	-416	-504	-586	-661	-597	-3,105
2. Require consistency in value for transfer and income tax purposes	DOE	---	23	53	102	118	127	134	140	146	152	146	424	1,142
3. Modify rules on valuation discounts	[19]	*Proposal Requires Additional Specification*												
4. Require a minimum term for grantor retained annuity trusts ("GRATs")	tca DOE	---	1	2	53	138	253	372	491	610	721	958	447	3,600
5. Limit duration of generation-skipping transfer ("GST") tax exemption	tca DOE	*Negligible Revenue Effect*												
Total of Reduce the Tax Gap and Make Reforms		**-5**	**-125**	**-1,693**	**-42,900**	**3,327**	**37,123**	**-831**	**-836**	**-5,291**	**3,540**	**-824**	**-4,271**	**-8,511**
XI. Upper-Income Tax Provision - Limit the Rate at Which Itemized Deductions can Reduce Tax Liability to a Maximum of 28 Percent	**tyba 12/31/11**	---	**3,794**	**20,291**	**25,261**	**27,682**	**30,271**	**32,819**	**35,209**	**37,316**	**39,294**	**41,326**	**107,299**	**293,261**
XII. User Fees - Reform Inland Waterways Funding [20]	**10/1/11**	**---**	**---**	**193**	**161**	**135**	**76**	**77**	**78**	**77**	**79**	**80**	**566**	**957**
XIII. Trade Provisions														
A. Afghan-Pakistan Reconstruction Opportunity Zone [7]	1/1/12	---	---	-1	-2	-5	-9	-16	-22	-32	-37	-39	-17	-163
B. Implement Free Trade Agreement with Panama [7]	1/1/12	---	[4]	[4]	[4]	[4]	-1	-1	-1	-1	-1	-2	-2	-6
C. Implement Free Trade Agreement with Columbia [7]	1/1/12	---	-88	-123	-136	-150	-167	-183	-196	-211	-228	-245	-664	-1,727
D. Implement Free Trade Agreement with Korea [7]	1/1/12	---	-293	-445	-536	-635	-747	-838	-916	-1,002	-1,101	-1,204	-2,655	-7,716
Total of Trade Provisions		**---**	**-381**	**-569**	**-674**	**-790**	**-924**	**-1,038**	**-1,135**	**-1,246**	**-1,367**	**-1,490**	**-3,338**	**-9,612**
XIV. Surface Transportation Reauthorization	**---**	***Proposal Requires Additional Specification***												
XV. Other Initiatives														
A. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents	DOE	*No Revenue Effect*												
B. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of our Economy	DOE	*No Revenue Effect*												

Provision	Effective	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
C. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration ("TIGTA")	tyba 12/31/11	*No Revenue Effect*												
D. Modify Indexing to Prevent Deflationary Adjustments	DOE	*No Revenue Effect*												
Total of Other Initiatives		***No Revenue Effect***												
XVI. Program Integrity Initiatives														
A. Implement Unemployment Insurance Integrity Legislation [2] [7]	DOE	---	---	-6	6	18	8	-3	-11	-16	-18	-22	27	-43
B. Increase Levy Authority for Payments to Federal Contractors with Delinquent Tax Debt	pma DOE	3	13	13	14	14	14	15	15	15	15	16	72	147
C. Increase Levy Authority for Payments to Medicare Providers with Delinquent Tax Debt	pma DOE	18	72	73	75	76	78	80	81	83	84	86	393	807
Total of Program Integrity Initiatives		**21**	**85**	**80**	**95**	**108**	**100**	**92**	**85**	**82**	**81**	**80**	**492**	**911**
XVII. Other Provisions														
A. Increase Duck Stamp Fees [7]	10/1/11	---	5	11	11	11	11	11	11	11	11	11	49	105
B. Levy a Fee on the Production of Hardrock Minerals to Restore Abandoned Mines [7]	10/1/12	---	---	150	150	150	150	150	150	150	150	150	600	1,350
Total of Other Provisions		**---**	**5**	**161**	**161**	**161**	**161**	**161**	**161**	**161**	**161**	**161**	**649**	**1,455**
NET TOTAL		**-2,103**	**-18,811**	**-194,354**	**-271,856**	**-245,007**	**-237,974**	**-304,018**	**-329,891**	**-358,269**	**-377,356**	**-412,062**	**-970,092**	**-2,751,683**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is generally assumed to be July 1, 2011.

[Legend and Footnotes for Appendix appear on the following pages]

Legend for the Appendix:

Legend for "Effective" column:

abiUSa = articles brought into the United States after
apa = appliances produced after
apoaa = amounts paid or accrued after
apoia = amounts paid or incurred after
ari = amounts realized in
bia = bonds issued after
cba = courses beginning after
ceia = contracts entered into after
cma = contributions made after
cmd = contributions made during
cmi = contributions made in
cpoia = costs paid or incurred after
cy = calendar year
da = day after
dA = designations after
Da = dispositions after
DA = distributions after
dda = decedents dying after
ddagma = decedents dying and gifts made after
dma = disclosures made after
dmi = distributions made in
DOE = date of enactment
dpoia = damages paid or incurred after
epoia = expenses paid or incurred after
epoid = expenses paid or incurred during
fsoua = fuel sold or used after
gma = gifts made after
haa = homes acquired after
ipa = interest paid after
lfa = loans forgiven after
ma = months after
oia = obligations issued after
oicsa = offers-in-compromise submitted after
pa = periods after
pii = policies issued in
pma = payments made after
pmtca = payments made to contractors after
ppisa = property placed in service after
ppisd = property placed in service during
proaa = payments received or accrued after
pyba = plan years beginning after
qfatpca = qualified film and television productions commencing after
qsbsaa = qualified small business stock acquired after
rrtbfa = returns required to be filed after
rrtbfea = returns required to be filed electronically after
saua = sales and uses after
sia = stock issued after
tca = trusts created after
trfa = tax returns filed after
tyba = taxable years beginning after
tyea = taxable years ending after
vsa = vehicles sold after
wpoifibwa = wages paid or incurred for individuals beginning work after

[Footnotes for the Appendix appear on the following pages]

Footnotes for the Appendix:

[1] To the extent the proposals are not fully specified, estimates will be updated as new information becomes available and policy intent is clarified.

[2] Estimate includes the following outlay effects [21]:	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
Retain 10% bracket	---	---	---	1,900	2,012	2,123	2,253	2,349	2,468	2,570	2,644	6,035	18,319
Standard deduction and 15% rate bracket set at 2 times single for married filing jointly	---	---	---	192	202	207	221	226	232	238	246	601	1,764
EITC modification and simplification	---	---	---	3,722	3,775	3,878	3,940	4,025	4,107	4,165	4,215	11,374	31,827
Retain the child tax credit at $1,000; refundable; AMT rules	---	---	---	15,095	15,399	15,852	16,069	16,301	16,431	16,492	16,530	46,346	128,169
Dependent care tax credit	---	---	---	59	235	238	239	237	230	223	216	532	1,676
Adoption credit	---	---	---	43	43	42	41	40	39	39	39	128	326
Reduce the earnings threshold for the refundable portion of the child tax credit to $3,000	---	---	---	10,250	10,166	10,093	9,991	9,960	9,837	9,778	9,751	30,509	79,826
Provide $250 refundable credit for Federal, State and local government retirees not eligible for Social Security benefits	---	125	---	---	---	---	---	---	---	---	---	125	125
Extend the EITC for Larger Families	---	---	---	1,717	1,723	1,753	1,774	1,805	1,829	1,861	1,894	5,192	14,356
Expand the child and dependent care tax credit	---	---	94	383	407	426	447	467	481	497	510	1,310	3,712
Provide for Automatic Enrollment in Individual Retirement Accounts or Annuities ("IRAs") and Double the Tax Credit for Small Employer Plan Startup Costs	---	---	---	263	282	304	327	352	377	400	422	849	2,727
Extend American Opportunity tax credit	---	---	---	2,339	2,185	2,087	2,036	1,995	1,975	1,895	1,930	6,611	16,442
Reform and Extend Build America Bonds	63	627	1,970	3,497	5,021	6,597	8,262	9,966	11,683	13,412	15,153	17,775	76,250
Restructure Assistance to New York City - provide tax incentives for transportation infrastructure	---	200	200	200	200	200	200	200	200	200	200	1,000	2,000
Grants for specified energy property	---	1,411	890	322	---	---	---	---	---	---	---	2,624	2,624
Increase in limit on cover over of rum excise tax revenues [7]	---	107	24	---	---	---	---	---	---	---	---	131	131
PPACA expansion of the adoption credit	---	---	784	-2	-1	---	---	---	---	---	---	781	781
Health coverage tax credit	54	95	40	12	11	10	10	10	9	9	8	222	268
Provide Short-Term Tax Relief to Employers and Expand Federal Unemployment Tax Act ("FUTA") Base [7] [22]	1,095	1,754	545	---	---	---	---	---	---	---	---	3,394	3,394
Expand short-time compensation unemployment program [7]	---	30	58	44	34	24	24	25	26	27	27	190	319
Implement unemployment insurance integrity legislation [7]	---	---	6	-5	-16	-9	-2	4	10	17	25	-24	30
Total Outlay Effects	1,212	4,349	4,611	40,031	41,678	43,825	45,832	47,962	49,934	51,823	53,810	135,705	385,066

[3] Estimate includes the following effects:	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2011-16	2011-21
Total Revenue Effects	---	---	-750	-1,022	-1,053	-1,085	-1,117	-1,151	-1,185	-1,221	-1,257	-3,910	-9,841
On-budget effects	---	---	-507	-692	-713	-734	-756	-779	-802	-826	-851	-2,646	-6,660
Off-budget effects	---	---	-243	-331	-340	-351	-361	-372	-383	-395	-406	-1,264	-3,181

[4] Loss of less than $500,000.

[5] Effective for elections under section 42(g)(1) that are made after the date of enactment.

[6] Effective for projects that are financed by tax-exempt bonds issued after the date of enactment.

[7] Estimate provided by the Congressional Budget Office.

[8] Gain of less than $500,000.

[Footnotes for the Appendix are continued on the following page]

Footnotes for the Appendix continued:

[9] Effective for dividends with respect to taxable years of regulated investment companies beginning after December 31, 2011.
[10] Estimate includes tax effects of interaction with extension of certain TAA provisions through 2011.
[11] Effective as if included in the "American Recovery and Reinvestment Tax Act of 2009."
[12] Effective for sales or assignment of interest in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2011.
[13] Effective for contacts issued after December 31, 2011, in taxable years ending after that date.
[14] Estimate includes changes to FUTA, lost FUTA credits, and State UI deposits and also contains outlay effects. The outlay effects are subject to change and affect 2011, 2012, and 2013.
[15] Effective for taxpayers attaining age 70 1/2 on or after December 31, 2011.
[16] Effective for transfers made under section 1041 after December 31, 2011.
[17] Effective for employment tax returns required to be filed with respect to wages paid after December 31, 2011.
[18] Negligible revenue effect.
[19] Effective for transfers after the date of enactment of property subject to restrictions created after October 8, 1990.
[20] Estimate provided by the Joint Committee on Taxation in collaboration with the Congressional Budget Office.
[21] The outlay effects are preliminary and subject to change since the individual model does yet not incorporate the exchange credits.
[22] The outlay effects are preliminary and subject to change.